

# RELINQUISH CONTROL! WHY THE IRS SHOULD CHANGE ITS STANCE ON EXEMPT ORGANIZATIONS IN ANCILLARY JOINT VENTURES

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## I. INTRODUCTION

In the midst of a national health care crisis involving over forty-three million uninsured Americans and another fifty million underinsured, a national debate is waging over the creation of a national health insurance program and the provision of health care services in this country.<sup>1</sup> On the sidelines of this debate, another nationwide conflict has developed over whether nonprofit hospitals and health care providers are fulfilling their charitable mission by providing enough charity care to patients with limited or no financial means to pay the exorbitant costs associated with current health care services.<sup>2</sup> To add fuel to that conflict, forty-six lawsuits have been filed in twenty-two states claiming that nonprofit hospitals are violating their tax-exempt status<sup>3</sup> by charging uninsured patients premium rates while granting deep discounts to private insurers and Medicare and Medicaid.<sup>4</sup> Newspaper articles abound with stories of uninsured and underinsured patients inundated with large hospital bills yet financially unable to make more than nominal payments per month.<sup>5</sup> In a sea of

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<sup>1</sup> H.R. 676, 108th Cong. (2004) (statement of Rep. John Conyers, Jr.), *available at* [http://www.house.gov/conyers/news\\_health\\_care.htm](http://www.house.gov/conyers/news_health_care.htm).

<sup>2</sup> *IRS Official Sees "Situation in Chaos" as Nonprofits Assess Charity Obligations*, DAILY TAX REP. (BNA) Dec. 8, 2004, at G-10.

<sup>3</sup> The terms "tax-exempt organization" and "exempt organization" are used interchangeably in this Article to refer to nonprofit organizations that qualify for, and have been granted, an exemption from federal income tax pursuant to I.R.C. § 501(c)(3). In addition, any reference to "exemption" or "tax-exempt" status is intended to refer exclusively to such status under federal income tax law and does not imply exemption under other federal tax laws, or under state or local laws, unless otherwise indicated.

<sup>4</sup> See Terry Carter, *Who Pays Hefty Hospital Tabs?*, 91 ABA JOURNAL, Jan. 2005, at 14; Ceci Connolly, *Tax-Exempt Hospitals' Practices Challenged*, WASH. POST, Jan. 29, 2005, at A1.

<sup>5</sup> See Connolly, *supra* note 4, at A1.

uninsured and underinsured patients along with constantly increasing costs for providing health care services, nonprofit hospitals are compelled to look for alternative revenue sources to remain afloat and to sustain their charitable mission. In the last two decades, tax-exempt health care providers have found such an alternative revenue source through participating in joint ventures with for-profit entities or individuals (hereinafter, "for-profit participants").<sup>6</sup>

Hospitals and health care providers are not the only tax-exempt, charitable organizations (hereinafter, collectively referred to as "exempt organizations")<sup>7</sup> whose role in society and charitable mission are subject to debate.<sup>8</sup> Exempt organizations other than hospitals are similarly faced with a chronic problem—finding new and consistent sources of revenue beyond the limited donation pool, consisting of private and governmental donors, which will provide them with the necessary resources to accomplish their charitable mission. Joint ventures with for-profit participants are an increasingly alternative and viable revenue source to fund their primary, charitable activities. For exempt health care organizations, in addition to extra revenue, a joint venture may provide needed capital, assist in recruiting or retaining necessary expertise, help pool the risk in a new enterprise or medical procedure, and help provide a new medical service or facility to an area in need.<sup>9</sup> For exempt educational organizations, a joint venture with private or governmental sponsors can ensure that the organization undertakes important research.<sup>10</sup> For other exempt charitable organizations, a joint venture is the necessary vehicle to develop housing that benefits low-income families and individuals while providing the development investors with desired tax credits.<sup>11</sup> In discussing the participation of exempt organizations in such joint ventures, this Article presupposes that such participation, in most circumstances, yields an ultimate societal good because it necessarily provides an exempt organization the ability to continue its charitable activities, resulting in a positive impact on the community as a whole.<sup>12</sup>

As the primary regulator of exempt organizations, the Internal Revenue Service (hereinafter, the "IRS") initially approached joint ventures involving for-profit participants with much skepticism and took a *per se* position that an organization risked its very exemption if it participated in such a venture or otherwise shared its net profits.<sup>13</sup> After its defeat in a landmark court deci-

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<sup>6</sup> MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS § 1.1 and Preface to Supplement (2d ed. 2000 & Supp. 2005).

<sup>7</sup> See *supra* note 3.

<sup>8</sup> J. Christine Harris, *NYU Conference Surveys Current Definition of Charity*, 39 EXEMPT ORG. TAX REV. 27 (2003).

<sup>9</sup> SANDERS, *supra* note 6, § 1.3, at 5.

<sup>10</sup> *Id.*, § 1.4, at 6.

<sup>11</sup> *Id.*, § 1.5, at 7.

<sup>12</sup> See *infra* notes 49-50 and accompanying text with respect to the involvement of exempt organizations in "commercial" enterprises; see also Jack E. Kams, *Justifying the Nonprofit Hospital Tax Exemption in a Competitive Market Environment*, 13 WIDENER L.J. 383 (2004) (addressing the continuing debate as to whether continuing tax exemption to nonprofit hospitals is justified in light of arguably substantially similar services being provided by their commercial, for-profit counterparts).

<sup>13</sup> See *infra* notes 110-14 and accompanying text.

sion,<sup>14</sup> the IRS abandoned its *per se* position and adopted a “two-prong test” for analyzing whether an exempt organization’s participation in a joint venture with for-profit participants jeopardized its tax-exempt status.<sup>15</sup> This two-pronged test eventually evolved into a facts-and-circumstances determination that focused on whether the exempt organization retained sufficient “control” over the joint venture activities, thereby ensuring that the organization’s own exempt, charitable purposes were furthered or accomplished through its participation in the joint venture and no more than incidental benefit, financial or otherwise, was conferred on the for-profit participants.<sup>16</sup> In response to the increasing number of tax-exempt hospitals entering into “whole hospital” joint ventures with for-profit participants (an arrangement in which the entire assets and operations of the hospital are transferred to a newly-created entity in which both the hospital and for-profit participants are joint owners),<sup>17</sup> the IRS issued Revenue Ruling 98-15, which officially established a standard of “control” requiring the exempt organization to retain numerical control of the joint venture’s governing board of directors.<sup>18</sup> Again, the IRS saw the exempt organization’s control of the venture as crucial because it provided the organization with an ability to ensure that its activities were exclusively in furtherance of its exempt purposes and served as a safeguard against too much benefit, financial or otherwise, being conferred on the for-profit participants.<sup>19</sup>

After the issuance of Revenue Ruling 98-15 and in subsequent case law that interpreted and applied it, the issue that remained was whether courts would equally apply the control standard enunciated in the ruling as to whole hospital joint ventures to an exempt organization’s participation in an “ancillary” joint venture. Unlike a whole hospital joint venture, an ancillary venture does not entail the contribution of all of an exempt organization’s assets, but rather only an insubstantial portion of the organization’s assets.<sup>20</sup> Furthermore, in contrast to a whole hospital joint venture where the exempt hospital’s sole activity after the venture is its interest in the venture itself, an exempt hospital or other charitable organization that participates in an ancillary joint venture continues the activities for which it was granted an exemption *in addition to* participating in the venture. Accordingly, the application of the same control standard to ancillary joint ventures is less necessary and overly intrusive. Nevertheless, until recently, the IRS consistently applied the control standard of Revenue Ruling 98-15 to ancillary joint ventures.<sup>21</sup>

<sup>14</sup> *Plumstead Theatre Soc’y v. Comm’r*, 74 T.C. 1324 (1980), *aff’d*, 675 F.2d 244 (9th Cir. 1982). For a more complete discussion of the implications of *Plumstead*, see *infra* notes 115-19 and accompanying text.

<sup>15</sup> Gen. Couns. Mem. 39,005 (June 28, 1983), 1983 IRS GCM LEXIS 56. For a more complete discussion of the implications of this ruling, see *infra* notes 120-29.

<sup>16</sup> *Id.*; see also SANDERS, *supra* note 6, § 4.2, at 120-21, and *infra* notes 142-74 and accompanying text.

<sup>17</sup> See *infra* notes 34-36 and accompanying text.

<sup>18</sup> Rev. Rul. 98-15, 1998-1 C.B. 718; see also *infra* notes 150-52 and accompanying text.

<sup>19</sup> THOMAS K. HYATT & BRUCE R. HOPKINS, *LAW OF TAX-EXEMPT HEALTH CARE ORGANIZATIONS* § 22.11, at 386 (2d ed. 2001 & Supp. 2004).

<sup>20</sup> See *infra* note 37 and accompanying text.

<sup>21</sup> See *infra* notes 221-27, 237 and accompanying text.

After much criticism and constant calls for guidance specific to ancillary joint ventures, the IRS issued Revenue Ruling 2004-51 in mid-2004, which specifically addresses an exempt organization's participation in an ancillary joint venture.<sup>22</sup> Although Revenue Ruling 2004-51 signifies indisputable progress in the IRS's views with respect to the proper federal income tax treatment of ancillary joint ventures, the ruling stops short of directly addressing the real questions and issues raised by ancillary joint ventures.<sup>23</sup> In response to such criticism by practitioners in the exempt organizations' sector, an IRS representative unofficially issued a poignant reminder—Revenue Ruling 98-15 is “still on the books” and “Revenue Ruling 2004-51 does nothing to modify Revenue Ruling 98-15.”<sup>24</sup> In other words, the control standard enunciated in Revenue Ruling 98-15 appears to be alive and well with respect to ancillary joint ventures, continuing to raise questions as to when and how it may be applied.

This Article attempts to provide a more tenable alternative to the control standard with respect to ancillary joint ventures. Implicit in this Article's proposal is the following notion: exempt organizations better serve the general public and more fully achieve their exempt purpose through their ability to enter into ancillary joint ventures that are not subject to onerous restrictions like the IRS's current control standard. As necessary background, Part II of this Article provides both a statutory framework and an analysis of related case law essential to understanding both the exemption from federal income tax and the significant issues raised by an exempt organization's participation in a joint venture with for-profit participants. In doing so, the Article tracks the evolution of the control standard and its application to ancillary joint ventures. Although most of the cases and rulings addressing joint ventures have evolved in the exempt hospital and health care setting, this Article and the proposal set forth herein are intended to have broad application to ancillary joint ventures involving exempt organizations with missions and activities other than health care. Part III of the Article discusses and critiques two noteworthy proposals that offer an alternative to the control standard. Finally, Part IV offers an alternative proposal that provides a two-prong approach to the proper federal income tax treatment of an exempt organization's participation in an ancillary joint venture. The alternative proposal suggests that the IRS already possesses the necessary statutory and regulatory resources that, with certain suggested modifications, will more appropriately determine ancillary joint ventures' federal income tax treatment without imposing an economically unrealistic and overbearing control standard.

## II. EVOLUTION OF CURRENT FEDERAL INCOME TAX LAW WITH RESPECT TO EXEMPT ORGANIZATIONS' PARTICIPATION IN JOINT VENTURES

In order to understand the exemption from federal income tax and the corresponding issues raised by an exempt organization's participation in a joint venture with for-profit participants, this Article first provides an explanation of

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<sup>22</sup> See *infra* note 266 and accompanying text.

<sup>23</sup> See *infra* notes 278-80 and accompanying text.

<sup>24</sup> See *infra* note 281 and accompanying text.

the statutory framework and an analysis of related case law, beginning with an explanation of what is meant by a "joint venture."

### A. Overview—What is a Joint Venture?

Although the term "joint venture" can be defined in many different ways, one court has defined it as follows:

[A] joint venture contemplates an enterprise jointly undertaken; [that] it is an association of such joint undertakers to carry out a single project for profit; [that] there must be a community of interest in the performance of a common purpose, a proprietary interest in the subject matter, a right to direct and govern the policy in connection therewith, [and] duty, which may be altered by agreement, to share both in profit and losses.<sup>25</sup>

Joint ventures are typically conducted by their participants through a business entity, usually a partnership,<sup>26</sup> or more recently, a limited liability company<sup>27</sup> that combines the limited liability benefit of a corporation with the beneficial federal income tax treatment accorded to partnerships. For federal income tax purposes, a partnership (and a limited liability company that does not elect otherwise)<sup>28</sup> is generally not taxed as an entity separate from its owners,<sup>29</sup> but rather is treated as a pass-through entity pursuant to which items of income, gain, loss, deduction, and credit pass through to its owners and are reported on their individual income tax returns.<sup>30</sup> Although generally treated as a partnership for federal income tax purposes,<sup>31</sup> a joint venture is distinguished from a partnership in that a joint venture "does not entail a continuing relationship among the parties,"<sup>32</sup> but rather reflects a single activity or undertaking by the parties. As discussed in Part I of this Article, participation in joint ventures presents exempt organizations with particular opportunities to further their exempt purposes, diversify their revenue source, and obtain needed capital or expertise in an increasingly competitive economic environment.<sup>33</sup>

With respect to an exempt organization, a joint venture is typically categorized as being either a "whole hospital" or "ancillary" joint venture. The whole hospital joint venture, which is also referred to as a "whole entity" joint venture

<sup>25</sup> Harlen E. Moore Charitable Trust v. United States, 812 F. Supp. 130, 132 (C.D. Ill. 1993), *aff'd*, 9 F.3d 623 (8th Cir. 1993) (citations omitted).

<sup>26</sup> REVISED UNIF. P'SHIP ACT § 202(a), 6 U.L.A. 92 (1997) (defining a partnership as an "association of two or more persons to carry on as co-owners a business for profit").

<sup>27</sup> SANDERS, *supra* note 6, §§ 1.2, 1.6. In fact, Rev. Rul. 98-15, 1998-1 C.B. 718 and the primary IRS guidance on whole hospital joint ventures, involved two scenarios of joint ventures in which the limited liability company was utilized as the joint venture entity. *See infra* note 150 and accompanying text.

<sup>28</sup> A limited liability company with two or more members may elect to be classified either as a partnership or a corporation for federal income tax purposes. *See* Treas. Reg. § 301.7701-2(a), 3(c) (as amended in 2003).

<sup>29</sup> I.R.C. § 701 (2004); Treas. Reg. § 1.701-1 (1956), 301.7701-3(b) (as amended in 2003).

<sup>30</sup> SANDERS, *supra* note 6, § 1.2, at 2; *see also* I.R.C. § 702 (2004), Treas. Reg. § 1.702-1 (as amended in 2002).

<sup>31</sup> I.R.C. §§ 761, 7701(a)(2) (2004); Treas. Reg. § 1.761-1(a) (as amended in 1997).

<sup>32</sup> SANDERS, *supra* note 6, § 1.2, at 2.

<sup>33</sup> *See supra* notes 9-11 and accompanying text.

in a non-health care context,<sup>34</sup> emerged in the early 1990s due to the financial and other needs of the health care industry.<sup>35</sup> Specifically, the term describes an arrangement in which the total assets and operations of a tax-exempt hospital are transferred to a joint venture entity, typically a limited liability company, in which both the hospital and for-profit participants are joint owners, and thereafter the hospital is operated as a for-profit entity.<sup>36</sup> An ancillary joint venture is typically defined as one that does not involve the contribution of all of an exempt organization's assets.<sup>37</sup> Thus, the term ancillary can theoretically encompass a wide range of joint ventures, including those where an exempt organization contributes only an insubstantial portion of its total assets to the joint venture or contributes a substantial portion of its assets, but not all of them. This Article focuses specifically on the federal income tax treatment of exempt organizations' participation in ancillary joint ventures.

## B. Current Federal Income Tax Law—Statutory and Case Law

### 1. Overview of the Federal Income Tax Exemption Scheme

In order to discuss in detail the current state of federal income tax law with respect to an exempt organization's participation in a joint venture with a for-profit entity, it is necessary to be familiar with how an organization initially obtains its exemption, including the various statutory and regulatory tests as well as legal doctrines that govern both its organization and operation. Accordingly, this Article provides a brief overview of the federal income tax exemption statute and the regulatory tests that must be satisfied before an exemption can be granted. In addition, fundamental concepts such as the private inurement prohibition, the private benefit doctrine, and the unrelated business income tax are briefly reviewed. Each of these concepts serves to govern an exempt organization's activities and ultimately preserve the organization's tax-exempt status.

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<sup>34</sup> See Darryll K. Jones, *Private Benefit and the Unanswered Questions From Redlands Surgical Services*, 29 EXEMPT ORG. TAX. REV. 433, 433 n.9 (2000).

<sup>35</sup> See Rochelle Korman & Dahlia Balsam, *Joint Ventures With For-Profits After Revenue Ruling 98-15*, 27 EXEMPT ORG. TAX. REV. 441, 445 (2000). See also Mary Jo Salins, et al., *Whole Hospital Joint Ventures*, MATERIALS FOR IRS EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 1999, at 3, available at <http://www.irs.ustreas.gov/charities/article/0,,id=96421,00.html> [hereinafter IRS CPE MATERIALS] ("Whole hospital joint ventures gained a foothold when exempt hospital systems found a need to control their revenue base, expand patient coverage, and compete for managed care and physician organization contracts due to major health care alliances forming among providers.").

<sup>36</sup> *Id.*; see also MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 296 (2004).

<sup>37</sup> HYATT & HOPKINS, *supra* note 19, Supp. § 22.11, at 74 n.107.1. The IRS actually places these joint ventures into two categories, "hospital subsidiary joint ventures" (exempt organization uses a subsidiary to participate in a joint venture involving less than all of its assets) and "hospital ancillary joint ventures" (exempt organization directly participates in the joint venture involving less than all of its assets). *Id.*

*a. The Organizational and Operational Tests*

Section 501(c)(3)<sup>38</sup> provides for the exemption from federal income tax of nonprofit corporations and certain other entities “organized and operated exclusively for religious, charitable, scientific, . . . or educational purposes, . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual.”<sup>39</sup> Numerous administrative ruling issued by the IRS and applicable regulations define the meaning of each exempt purpose listed in the statute (i.e., religious, charitable, educational, etc.). For instance, with respect to the meaning of “charitable,” the IRS has recognized that, among other activities, the promotion of health care constitutes a charitable purpose under Section 501(c)(3), provided the organization satisfies the “community benefit standard.”<sup>40</sup> As a result, numerous nonprofit hospitals are tax-exempt organizations.

As set forth in applicable regulations, the language of Section 501(c)(3) establishes both an “organizational test” and an “operational test,” and if an organization seeks to qualify for exemption thereunder, it must not fail to meet either test.<sup>41</sup> The organizational test relates solely to the language used in the organization’s governing documents—its articles of incorporation (if a nonprofit corporation) or trust instrument (if a charitable trust). Under the test as set forth in the regulations, an organization is organized exclusively for one or more tax-exempt, charitable purposes only if its articles of organization: (i) limit its purpose to one or more exempt purposes; and (ii) do not expressly empower it to engage, otherwise than as insubstantial part of its activities, in activities that in themselves do not further one or more exempt purposes.<sup>42</sup> Accordingly, an organization that is empowered by its articles “to engage in operating a restaurant” or “to engage in the operation of a social club” does not meet this organizational test regardless of whether its articles state that it is created for exempt purposes within the meaning of Section 501(c)(3).<sup>43</sup> The organizational test also imposes requirements as to the distribution of the organization’s assets upon dissolution.<sup>44</sup>

The operational test, which is referenced frequently throughout this Article, is intended to ensure that the organization’s resources and activities are

<sup>38</sup> Unless otherwise indicated, all “Section” references are to the Internal Revenue Code of 1986, as amended.

<sup>39</sup> I.R.C. § 501(c)(3) (2004).

<sup>40</sup> See Rev. Rul. 69-545, 1969-2 C.B. 117. The “community benefit standard” requires that a hospital, in order to be exempt under I.R.C. § 501(c)(3) must: (i) maintain an emergency room that is “open to all persons” (i.e., no one requiring emergency care is denied treatment); (ii) provide hospital care for all persons in the community able to pay the cost thereof *either* directly or through third party reimbursement (including both private health insurance or public programs such as Medicare); (iii) maintain an open medical staff, with members of its active staff having the privilege of leasing available space in its medical building; and (iv) ensure that control of the hospital rests with a community board of trustees comprised of independent civic leaders. See also Rev. Rul. 83-157, 1983-2 C.B. 94.

<sup>41</sup> Treas. Reg. § 1.501(c)(3)-1(a)(1) (as amended in 1990).

<sup>42</sup> Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (as amended in 1990).

<sup>43</sup> Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii) (as amended in 1990).

<sup>44</sup> Treas. Reg. § 1.501(c)(3)-1(b)(4) (as amended in 1990) (requiring that the organization either in its Articles or under governing state law, must explicitly dedicate its assets to one or more exempt purposes in the event of dissolution).

devoted primarily to its exempt purposes. The regulations break down the operational test into two components commonly referred to as (i) the primary purpose or activity test, and (ii) the private inurement prohibition.<sup>45</sup> Under the primary purpose or activity test, an organization will be regarded as “operated exclusively” for one or more exempt purposes only if it “engages *primarily* in activities which accomplish one or more of such exempt purposes in Section 501(c)(3).”<sup>46</sup> An organization will not be regarded as primarily furthering its exempt purposes if “*more than an insubstantial part* of its activities is not in furtherance of an exempt purpose.”<sup>47</sup> Under the private inurement prohibition, the regulations provide that an organization will not meet the operational test “if its net earnings *inure in whole or in part* to the benefit of private shareholders or individuals.”<sup>48</sup> This prohibition is discussed in greater detail below.

The major impact of the primary purpose test, based on the term “primarily” utilized in the regulations, is that an organization exempt under Section 501(c)(3) may engage in an insubstantial amount of business activities unrelated to its exempt purpose without risking loss of its exemption, but the net income from any such business is potentially subject to the unrelated business income tax under Section 511, as discussed below.<sup>49</sup> However, if the organization’s primary purpose is the operation of a trade or business, it likely will not qualify for exemption.<sup>50</sup> For instance, an organization will not be considered as organized and operated for exempt purposes if its sole activity is the manufacture of pasta products even if all of its profits are to be distributed to a tax-exempt educational institution.<sup>51</sup> Accordingly, the focus of the operational test is on the actual purposes the organization advances or fulfills through its activi-

<sup>45</sup> Treas. Reg. § 1.501(c)(3)-1(c)(1), (2) (as amended in 1990).

<sup>46</sup> Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990) (emphasis added).

<sup>47</sup> *Id.* (emphasis added).

<sup>48</sup> Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 1990) (emphasis added).

<sup>49</sup> I.R.C. § 511 (2004); *see also infra* notes 77-102 and accompanying text.

<sup>50</sup> This is sometimes referred to as the “commerciality doctrine”—where the business or commercial activity is not in furtherance of exempt purposes and is substantial in size and scope. *See* BRUCE R. HOPKINS, *THE LAW OF EXEMPT ORGANIZATIONS* § 4.5(a) (8th ed. 2003 & Supp. 2004). *See also* Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990), which provides:

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined section 513.

*See infra* notes 83-89 and accompanying text for further discussion on the tax consequences of an exempt organization’s participation in unrelated trade or business activities. It is important to note that any failure to meet the operational test cannot be rectified by referring to language in the governing documents (i.e., articles of incorporation). HOPKINS, at § 4.5(a).

<sup>51</sup> *See* C. F. Mueller Co. v. Comm’r, 14 T.C. 922, 931-932 (1950), *rev’d* 190 F.2d 120 (3d Cir. 1951). The IRS and the Tax Court rejected the petitioner’s position that it qualified as an exempt organization under the “destination-of-income test.” *Id.* The Tax Court reiterated the statutory requirement that an organization be organized “exclusively” for one or more exempt purposes and further stated:

One cannot say properly that a corporation was organized and operated *exclusively* for educational purposes where, as here, one of its important purposes was to conduct a large commercial business for profit, competing with other similar corporations all subject to tax, and where the



ties, not on its statement of purposes or the nature of its activities.<sup>52</sup> This focus implicitly recognizes that an organization may conduct a trade or business activity that is related to or furthers its exempt purposes, thereby maintaining its exempt status under Section 501(c)(3).<sup>53</sup> This distinction between activities and purpose is an important aspect of the operational test and one that can be overlooked by both the IRS and the courts.<sup>54</sup> Such distinction will be discussed in greater detail below in the context of both the private benefit doctrine and the unrelated business income tax.

*b. Private Inurement and Private Benefit*

The private inurement prohibition and the private benefit doctrine are fundamental components of an organization's tax-exempt status under Section 501(c)(3) and are, therefore, a primary focus of the IRS in scrutinizing joint ventures between an exempt organization and an individual or for-profit entity.<sup>55</sup> These doctrines are often incorrectly used interchangeably.<sup>56</sup> However, fundamental differences between the two concepts exist, the importance of which will be further revealed in Part III of this Article.<sup>57</sup>

As previously stated, an organization exempt under Section 501(c)(3) must be organized and operated in a manner that effectively prevents it from distributing its net earnings to "private shareholders or individuals."<sup>58</sup> The prohibition is absolute—any amount of inurement is impermissible.<sup>59</sup> As stated by the IRS Chief Counsel, "[i]nurement is likely to arise where the financial benefit represents a transfer of the [exempt] organization's financial resources to an individual solely by virtue of the individual's relationship with the organization, and without regard to accomplishing exempt purposes."<sup>60</sup> The term "private shareholder or individual" is defined as "persons having a personal and private interest in the activities of the organization."<sup>61</sup> The key to the application of this prohibition is that the transaction at issue must involve such a person, commonly referred to as an "insider." Typically, an insider is an officer,

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operation of that business is not merely incidental to the conduct by the same corporation of any other overshadowing exempt activity.

14 T.C. at 931-32. The Third Circuit reversed the Tax Court finding that the destination-of-income test was rooted in public policy, but noted that its interpretation was no longer relevant due to the enactment of the UBIT that was effective after December 31, 1950. 190 F.2d at 120.

<sup>52</sup> HOPKINS, *supra* note 50, § 4.5(a), at 82.

<sup>53</sup> *Id.* at 83.

<sup>54</sup> *Id.* at 84.

<sup>55</sup> SANDERS, *supra* note 6, § 5.1(a), at 181.

<sup>56</sup> *Distinguishing Between Private Benefit and Inurement*, TAX-EXEMPT ADVISOR (CCH), Dec. 11, 2000, at 9 [hereinafter TAX-EXEMPT ADVISOR].

<sup>57</sup> See *infra* notes 302-24 and accompanying text for further discussion on the expansion of the private benefit doctrine in the joint venture context.

<sup>58</sup> See *supra* note 48 and accompanying text.

<sup>59</sup> SANDERS, *supra* note 6, § 5.1(b), at 183.

<sup>60</sup> I.R.S. Gen. Couns. Mem. 38,459 (July 31, 1980), available at 1980 IRS GCM LEXIS 71.

<sup>61</sup> Treas. Reg. § 1.501(a)-1(c) (as amended in 1982). I.R.S. Gen. Couns. Mem. 39,862 (Dec. 2, 1991), available at 1991 IRS GCM LEXIS 39 (describing the term as encompassing "persons who, because of their particular relationship with an organization, have an opportunity to control or influence its activities").

director, member, or other person in a position to assert influence or control over the organization's operations and activities.<sup>62</sup> For instance, at one time, the IRS's position was that all physicians were *per se* insiders with respect to the tax-exempt hospital where they were on staff.<sup>63</sup> This position was based on the reciprocal economic dependency between the two—the physicians have a personal interest in the hospital's operations and thus are able to influence or control the hospital through referrals and patient treatment.<sup>64</sup>

The private inurement doctrine does not prohibit transactions between an exempt organization and an insider, but rather requires that any such transaction be reviewed for reasonableness.<sup>65</sup> Typically, private inurement is found to exist in transactions with insiders involving the payment of excessive compensation, the purchase or sale of assets on a non-fair-market-value basis, and the use of the exempt organization's assets to pay an insider's personal expenses.<sup>66</sup> Prior to the enactment of the intermediate sanction rules under Section 4958, as discussed in greater detail in Part IV of this Article, the IRS customarily revoked the exemption of organizations determined to have violated the private inurement prohibition.<sup>67</sup>

As with the existence of any private inurement, an organization cannot be exempt under Section 501(c)(3) if it fails to satisfy the private benefit doctrine. The doctrine originates not from the statute itself but from the regulations, which state that an organization is not organized or operated exclusively for one or more exempt purposes "unless it serves a public *rather than* a private interest."<sup>68</sup> Accordingly, the doctrine is a "derivative of the operational test"—i.e., it is inherent in the operational test that an exempt organization must operate *primarily* for exempt purposes and not for private benefit.<sup>69</sup> The scope of the private benefit doctrine is extremely broad and looks to all of the activities of an organization in determining whether the organization primarily operates for public rather than private benefit. Thus, in contrast to the private inurement prohibition, an *incidental* amount of private benefit can occur without jeopard-

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<sup>62</sup> SANDERS, *supra* note 6, § 5.1(b), at 183. See also *infra* notes 395-99 and accompanying text for a discussion of the appellate decision in *United Cancer Council, Inc. v. Comm'r* which affected the "insider" definition. 165 F.3d 1173 (7th Cir. 1999), *rev'g and remanding* 109 T.C. 326 (1997).

<sup>63</sup> See I.R.S. Gen. Couns. Mem. 39,862 (Dec. 2, 1991), *available at* 1991 IRS GCM LEXIS 39.

<sup>64</sup> TAX-EXEMPT ADVISOR, *supra* note 56, at 9. The IRS now takes the position that whether a physician is an insider depends on a more functional, facts-and-circumstances analysis which looks to the "reality of control" rather than the individual's place in the organization's structure. See Lawrence M. Brauer & Charles F. Kaiser III, *Physician Incentive Compensation*, IRS CPE MATERIALS FOR FY 2000, at 26, <http://www.irs.ustreas.gov/pub/irs-tegel/eotopic00.pdf>.

<sup>65</sup> HYATT & HOPKINS, *supra* note 19, § 4.1, at 57.

<sup>66</sup> Celia Roady, *Intermediate Sanctions*, 884 TAX MGMT. ESTS., GIFTS, & TRS. J. (BNA) (2004).

<sup>67</sup> *Id.* The concept of an "insider" and transactions that violate the private inurement prohibition are directly imported into the definitions of a "disqualified person" and "excess benefit transaction" under the intermediate sanction rules. However, it is not yet clear what effect these statutory terms will have on private inurement and the common law concept of an insider. See *infra* note 364 and accompanying text.

<sup>68</sup> Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990) (emphasis added).

<sup>69</sup> HOPKINS, *supra* note 50, § 19.10, at 522.

izing an organization's exemption.<sup>70</sup> The result is a balancing test whereby the IRS determines whether a particular private benefit is outweighed by the public benefit conferred on the community as a whole.<sup>71</sup>

In addition, where the private inurement prohibition only applies if undue benefit is conferred to an insider, the private benefit doctrine applies if an impermissible benefit is being conferred on unrelated third parties or "disinterested persons" as well.<sup>72</sup> Accordingly, a situation can exist in which private benefit may exist without any private inurement.<sup>73</sup> For example, if an exempt organization executes a contract with a fundraising consultant who is not an officer or board member of the organization and who retains ninety percent of any contributions received as a result of his fundraising efforts, the private benefit doctrine likely applies because the organization is operating more for private rather than public interests. However, because the fundraiser is not a board member or officer of the organization, he will not be considered an insider and, therefore, the private inurement prohibition does not apply.<sup>74</sup> It is this broad scope of the private benefit doctrine, which encompasses and examines all of an organization's activities (i.e., exempt activities, transactions with insiders and/or with unrelated disinterested persons), that has resulted in an aggressive expansion and application of the doctrine by the IRS in the context of joint ventures. The expansion of the private benefit doctrine in the context of joint ventures will be discussed in greater detail in Part III of this Article.<sup>75</sup>

It is important to note that although private inurement and private benefit are distinct, some see the development of the intermediate sanctions rules under Section 4958, discussed in Part IV of this Article, as affecting both doctrines because "their concepts are interrelated" and their bodies of law are "similar to or parallel to the intermediate sanctions concepts."<sup>76</sup>

### c. *Unrelated Business Income Tax*<sup>77</sup>

The concept of an unrelated trade or business activity carried on by an exempt organization originates from the operational test; specifically, the primary purpose component of the test, as discussed above.<sup>78</sup> Under this test, an exempt organization may engage in trade or business activities that are *unrelated* to its exempt purposes provided the activities are only *incidental* to, or

<sup>70</sup> *Id.* Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990). See also *Better Bus. Bureau of D.C. Inc. v. United States*, 326 U.S. 279, 283 (1945) (holding that "[a] substantial non-educational purpose will disqualify an organization from tax exemption despite the number or importance of its exempt purposes.") (emphasis added).

<sup>71</sup> TAX-EXEMPT ADVISOR, *supra* note 56, at 9.

<sup>72</sup> *Id.*

<sup>73</sup> For additional discussion on the distinction between the private inurement prohibition and the private benefit doctrine, see HOPKINS, *supra* note 50, § 19.10, and SANDERS, *supra* note 6, § 5.1(c).

<sup>74</sup> See *infra* notes 395-98 and accompanying text.

<sup>75</sup> See *infra* notes 302-24 and accompanying text.

<sup>76</sup> See SANDERS, *supra* note 6, § 5.2, at 189.

<sup>77</sup> A treatise can be written on the unrelated business income tax ("UBIT") and the numerous issues and nuances which now saturate this area of tax-exempt law. However, the discussion herein is only intended to provide an overview so that later references to the UBIT and its effect on joint ventures can be readily grasped and understood.

<sup>78</sup> See *supra* notes 50-54 and accompanying text.

less than a substantial part of, its exempt purpose activities. If an organization's *primary* purpose is the operation of a trade or business unrelated to its exempt purposes it will not qualify for exemption under Section 501(c)(3) because, in such instances, the organization is essentially equivalent to a for-profit business entity.<sup>79</sup> As a consequence, the "unrelated business income tax" (hereinafter referred to as the "UBIT") imposed under Section 511 targets only income that an exempt organization receives from its trade or business activities that are unrelated to, and represent an insubstantial part of, its overall exempt purposes.

The primary objective of the UBIT is to "eliminate a source of unfair competition" with for-profit businesses, by subjecting the unrelated business activities of exempt organizations to the same tax consequences as the non-exempt business endeavors with which they compete.<sup>80</sup> Furthermore, it ensures that an exempt organization cannot "commercially exploit its exempt status for the purpose of unfairly competing with taxpaying organizations."<sup>81</sup> Accordingly, the UBIT imposes the same tax rates as those imposed on the income of for-profit corporations.<sup>82</sup>

The UBIT is specifically imposed on "unrelated business income," statutorily defined as income from an "unrelated trade or business" which is "regularly carried on."<sup>83</sup> An unrelated trade or business is defined as a trade or business activity that is not "substantially related" to the exempt organization's exercise or performance of its exempt purpose or function.<sup>84</sup> To be considered "related" to an organization's exempt purposes or function, the conduct of the business activities must have a "causal relationship to the achievement of exempt purposes (other than through the production of income)."<sup>85</sup> Such causal relationship is "substantial" if "the production or distribution of the goods or the performance of the services from which the gross income is derived . . . contribute[s] importantly to the accomplishment of those purposes."<sup>86</sup> Therefore, the relationship between the business activity that generates the income in issue and the accomplishment of the organization's exempt

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<sup>79</sup> See *supra* notes 50-52 and accompanying text.

<sup>80</sup> Treas. Reg. § 1.513-1(b) (as amended in 1983).

<sup>81</sup> HOPKINS, *supra* note 50, § 26.1 (citing S. REP. NO. 94-938, 601 (1976)).

<sup>82</sup> See I.R.C. § 511(a)(1) (2004), referring to I.R.C. § 11 (2004).

<sup>83</sup> I.R.C. § 512(a)(1) (2004). The term "trade or business" is defined to include "any activity which is carried on for the production of income from the sale of goods or the performance of services." I.R.C. § 513(c) (2004). Such trade or business activities of an exempt organization are considered as "regularly carried on" if they "manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations." Treas. Reg. § 1.513-1(c)(1) (as amended in 1983). I.R.C. 512(b) (2004) provides certain exceptions to the definition of unrelated business income including dividends, interest, rents, royalties, and gain on sales of non-inventory property, unless any of these items (except dividends) originate from a controlled subsidiary or debt-financed property.

<sup>84</sup> I.R.C. § 513(a) (2004).

<sup>85</sup> Treas. Reg. § 1.513-1(d)(2) (as amended in 1983).

<sup>86</sup> *Id.* In determining whether activities "contribute importantly" to the accomplishment of an exempt purpose, "the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve." Treas. Reg. § 1.513-1(d)(3) (as amended in 1983).

purposes must necessarily be examined.<sup>87</sup> For instance, organizations whose primary activities consist of operating a trade or business that furthers their exempt purposes or functions are museums, hospitals, social service agencies, colleges and universities.<sup>88</sup>

The regulations provide as an example an organization exempt under Section 501(c)(3) that operates a school for training children in the performing arts, such as acting, singing, and dancing. The organization is not subject to UBIT on the income it derives from admissions charged at student performances because the performances contribute importantly to the accomplishment of its exempt, educational purposes.<sup>89</sup> Likewise, a tax-exempt hospital's participation in a joint venture with physicians to operate an ambulatory surgical center or medical imaging facility can be substantially related to, and thereby further, its exempt purpose of promoting the health of the community.<sup>90</sup> Accordingly, based on the above explanation, an exempt organization must necessarily segregate its trade or business activities into two categories in order to determine UBIT applicability: (i) Those activities that are unrelated to its exempt purposes and represent only an insubstantial portion of its overall activities, the income from which is subject to the UBIT; and (ii) those activities that are substantially related to its exempt purpose or function and, thus, not subject to the UBIT.<sup>91</sup>

For exempt organizations that engage in unrelated business activities and pay the UBIT on the income from those activities, a fundamental issue arises—at what level of activity or amount of income will an exempt organization's unrelated business activities be considered more than "insubstantial," thereby jeopardizing its tax-exempt status?<sup>92</sup> Organizations have traditionally failed to qualify for exemption if a substantial portion of their income is from unrelated activities.<sup>93</sup> For instance, the IRS has held that an organization's exemption may be denied or revoked if it earns greater than fifty percent of its annual receipts from unrelated business activities.<sup>94</sup> Although there is no bright-line rule or percentage limitation, the common measure of substantiality or lack thereof has been in terms of percentage of time or expenditures.<sup>95</sup> For example, an organization was denied tax-exempt status because it received approximately one-third of its revenues from unrelated business activities.<sup>96</sup> However, there has not been consistent application of any one standard by the IRS or the

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<sup>87</sup> HOPKINS, *supra* note 50, § 26.4, at 763.

<sup>88</sup> FRANCES R. HILL & DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* ¶ 21.03[1][a] (2003).

<sup>89</sup> Treas. Reg. § 1.513-1(d)(4), Ex. 1 (as amended in 1983).

<sup>90</sup> See, e.g., I.R.S. Priv. Ltr. Rul. 2001-18-054 (Feb. 7, 2001).

<sup>91</sup> HOPKINS, *supra* note 50, § 26.1, at 744.

<sup>92</sup> See HILL & MANCINO, *supra* note 88, ¶ 21.03[1][a].

<sup>93</sup> HOPKINS, *supra* note 50, § 26.1, at 745 citing People's Educ. Camp Soc'y, Inc. v. Comm'r, 331 F.2d 923 (2d Cir. 1964); Indiana Retail Hardware Ass'n v. United States, 366 F.2d 998 (Ct. Cl. 1966); Rev. Rul. 69-220, 1969-1 C.B. 154.

<sup>94</sup> HOPKINS, *supra* note 50, § 26.1, at 745; see also I.R.S. Gen. Couns. Mem. 39,108 (Dec. 23, 1982), available at 1983 IRS GCM LEXIS 147.

<sup>95</sup> HOPKINS, *supra* note 50, § 26.1, at 745.

<sup>96</sup> *Id.*; see Orange County Agric. Soc'y, Inc. v. Comm'r, 893 F.2d 529 2d Cir. 1990), *aff'd* 55 T.C.M. 1602 (1988).

courts in determining whether an organization's unrelated business activities are substantial or not.<sup>97</sup>

Periodically, the IRS will apply a "commensurate in scope" test, first articulated in a 1964 revenue ruling, which compares the extent of an exempt organization's financial resources to its exempt activities or efforts.<sup>98</sup> Under this test, a substantial portion of an exempt organization's total revenues may flow from unrelated business activities, but not affect its tax-exempt status if a significant amount of the organization's time and efforts are spent on its exempt functions or activities.<sup>99</sup> However, the ruling failed to provide any quantitative measure or standard for determining whether an organization's exempt activities would be "commensurate in scope" with its financial resources.<sup>100</sup> Nevertheless, in subsequent technical advice, the IRS concluded that an organization organized and operated for charitable purposes that earned ninety-eight percent of its income from unrelated business activities was still exempt under Section 501(c)(3) because greater than forty percent of its time was expended on exempt programs or activities.<sup>101</sup>

Although a significant amount of legal scholarship and IRS administrative guidance have focused on the UBIT and whether too much unrelated business activity can jeopardize an organization's tax-exempt status, the breadth of the topic is beyond the scope of this Article.<sup>102</sup> The important point to take away from this discussion is that there is no clearly articulated standard that definitively resolves the issue of when an organization engages in too "substantial" an amount of unrelated business activity and, as a result, threatens the denial or

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<sup>97</sup> HOPKINS, *supra* note 50, § 26.1, at 745; I.R.S. Tech. Adv. Mem. 2000-21-056 (May 25, 2000) (there is no "quantitative limitation" on the amount of unrelated business in which an exempt organization may engage), and *Nationalist Movement v. Comm'r*, 102 T.C. 558, 589 (1994), *aff'd*, 37 F.3d 216 (5th Cir. 1994) ("[w]hether an activity is substantial is a facts-and-circumstances inquiry not always dependent on time or expenditure percentages").

<sup>98</sup> Rev. Rul. 64-182, 1964-1 C.B. 186. In the revenue ruling, the organization owned and operated a commercial office building, the rental income from which comprised one hundred percent of the organization's income. Although the income was from an unrelated business activity, the IRS concluded that the organization was exempt under I.R.C. § 501(c)(3) (2004) because its primary exempt function or activity—making grants to other exempt, charitable organizations—was "commensurate in scope with its financial resources." *Id.*

<sup>99</sup> HOPKINS, *supra* note 50, § 26.1, at 745.

<sup>100</sup> HILL & MANCINO, *supra* note 88, ¶ 21.03[1][a].

<sup>101</sup> I.R.S. Tech. Adv. Mem. 97-11-003 (Nov. 8, 1995). The organization received ninety-eight percent of its revenue from bingo games. Although the organization represented that it dedicated more than fifty percent of its time and resources to the bingo games, the IRS nevertheless dismissed any "commensurate" issue by relying on the fact that the organization had expended greater than forty percent of its time and resources to the assistance of developmentally disabled children over the past thirty years. *Id.* Accordingly, the IRS concluded that the commensurate-in-scope test was not applicable because the organization had a "substantial charitable program in addition to its fundraising activities." *Id.*

<sup>102</sup> For an in-depth discussion of UBIT and tax-exempt status, see John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 33 EXEMPT ORG. TAX REV. 341 (2003); see also John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487 (2002).

revocation of its tax-exempt status.<sup>103</sup> The relevance and importance of this point is further illuminated in Part III of this Article.

## 2. *Exempt Organizations as Passive Participants In Joint Ventures Involving For-Profit Participants*

As previously discussed, several types of entities can be used to effect a joint venture between an exempt organization and for-profit participants, the most common of which are general partnerships, limited partnerships, and limited liability companies.<sup>104</sup> The federal income tax consequences to the exempt organization depend primarily on whether it is an "active" or "passive" participant in the joint venture. Historically, an exempt organization's "active" participation in a joint venture (i.e., a partner in a general partnership, a general partner in a limited partnership, or a member in a limited liability company<sup>105</sup>) with for-profit participants has invited intense IRS scrutiny, with possible loss of its tax-exempt status.<sup>106</sup> Exempt organizations can also participate as limited partners in joint ventures, commonly referred to as "passive investors," where they are only liable for their investment in the entity and do not generally participate in the management of the venture. As a "passive" participant in a joint venture, the exempt organization's typical federal income tax consequence is whether the income it receives from the venture is subject to the UBIT.<sup>107</sup> This distinction is important as this Article focuses exclusively on the "active," as opposed to the "passive," participation of exempt organizations in joint ventures with for-profit participants.<sup>108</sup>

## 3. *Exempt Organizations as Active Participants In Joint Ventures Involving For-Profit Participants*

### a. *Evolution of the Two-Prong Test*

Prior to the United States Tax Court's decision in *Plumstead Theatre Society v. Commissioner*,<sup>109</sup> discussed below, an organization exempt under Section 501(c)(3) ceased to qualify as such if it participated in a partnership or other type of joint venture entity (i.e., limited partnership, limited liability com-

<sup>103</sup> See FREMONT-SMITH, *supra* note 36, at 299 ("[T]he Internal Revenue Code is unclear as to whether there is a limit to the amount of commercial activity, both related and unrelated, beyond which an organization will not be entitled to tax exemption.").

<sup>104</sup> See *supra* notes 26-32 and accompanying text.

<sup>105</sup> An exempt organization's participation in a joint venture formed as a limited liability company does raise the issue as to whether it may invest or participate as a "non-managing member," analogous to the "passive investor" role of a limited partner in a limited partnership, which typically results in reduced IRS scrutiny and only possible UBIT consequences. See *infra* note 107 and accompanying text. Because all members of an LLC have a right to participate in its management, it is unclear whether such passive participation will be acknowledged by the IRS. See SANDERS, *supra* note 6, § 1.8 n.81, and § 4.3 n.194.

<sup>106</sup> Korman & Balsam, *supra* note 35.

<sup>107</sup> SANDERS, *supra* note 6, § 1.8, at 11, *citing* Treas. Reg. § 1.512(c)-1 (1958).

<sup>108</sup> Furthermore, this Article does not address an exempt organization's participation in a joint venture, ancillary or whole entity, with one or more other exempt organizations.

<sup>109</sup> *Plumstead Theatre Soc'y v. Comm'r*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

pany) or if it otherwise shared its net profits.<sup>110</sup> This “*per se* position”<sup>111</sup> taken by the IRS was exemplified in General Counsel Memorandum (“GCM”) 36,293,<sup>112</sup> wherein the exempt organization, a corporation organized to provide low- and moderate-income housing on a nondiscriminatory basis, planned to form a limited partnership that would own and rent the housing. The exempt organization would serve as the general partner of the limited partnership while private investors, who supplied the necessary capital for the venture, would be limited partners. The IRS Chief Counsel concluded that the limited partnership was nothing more than a vehicle for the exempt organization to share the net profits of an income-producing venture with private individuals, thereby making the venture inherently incompatible with the operational test of Section 501(c)(3).<sup>113</sup> The Chief Counsel stated:

By agreeing to serve as the general partner of the proposed housing project, the Corporation [exempt organization] would take on an obligation to further the private financial interests of the limited partners. . . . [T]he Corporation’s assumption of a duty to promote such interests in its capacity as general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes.<sup>114</sup>

The IRS’s *per se* position on the participation of exempt organizations in joint ventures with for-profit participants began to erode with the Tax Court’s landmark decision in *Plumstead Theatre Society v. Commissioner*.<sup>115</sup> In *Plumstead*, a California nonprofit corporation, exempt from federal income tax under Section 501(c)(3) (the “Society”), was created to promote and encourage the understanding of, and public interest in, the theater and the arts.<sup>116</sup> The Society entered into an agreement with the John F. Kennedy Center for the Performing Arts in Washington, D.C., also an exempt organization, to co-produce a play starring the Society’s president, Henry Fonda. Pursuant to their agreement, the Society and the Kennedy Center each provided one-half of the production costs and shared equally in profits and losses.<sup>117</sup>

Prior to the premiere of the co-produced play, the Society experienced difficulty raising its share of the production costs. Accordingly, it entered into a limited partnership in which it served as a general partner, the limited partners of which were two individuals and a for-profit corporation. Pursuant to the

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<sup>110</sup> SANDERS, *supra* note 6, § 4.2, at 120.

<sup>111</sup> *Id.*

<sup>112</sup> I.R.S. Gen. Couns. Mem. 36,293 (May 30, 1975), available at 1975 IRS GCM LEXIS 215; see also I.R.S. Gen. Couns. Mem. 37,259 (Sept. 19, 1977), available at 1977 IRS GCM LEXIS 372.

<sup>113</sup> See I.R.S. Gen. Couns. Mem. 36,293. The memorandum specifically states that, “[b]y agreeing to serve as the general partner of the proposed housing project, the Corporation [exempt organization] would take on an obligation to further the private financial interests of the limited partners.” *Id.*

<sup>114</sup> *Id.* The GCM further states that “the service of private interests by means of any arrangement involving such a conflict of interest would also preclude any given organization of that kind from being treated as one ‘operated exclusively for the promotion of social welfare’” within the meaning of I.R.C. § 501(c)(4) (2004). *Id.*

<sup>115</sup> *Plumstead Theatre Soc’y v. Comm’r*, 74 T.C. 1324, 1324 (1980), *aff’d*, 675 F.2d 244 (9th Cir. 1982).

<sup>116</sup> *Id.* at 1325.

<sup>117</sup> *Id.* at 1327.



limited partnership agreement, the Society contributed its contractual rights under its agreement with the Kennedy Center and the limited partners contributed capital in exchange for a sixty-three and one-half percent share in any profits or losses resulting from the production of the play.<sup>118</sup>

In determining whether the Society continued to satisfy the operational test under Section 501(c)(3) after its participation in the limited partnership, the Tax Court rejected the IRS's contention that the Society had a substantial commercial purpose due to such participation and concluded that the Society's obligations under the limited partnership agreement were not incompatible with its tax-exempt status for the following reasons: (i) The Society's sale of its rights in the Kennedy Center agreement was achieved through an arm's-length transaction for a reasonable price; (ii) the Society was not obligated to return the limited partners' capital contributions from its own funds; (iii) the limited partnership had no interest in, nor any control over the activities of, the Society; and (iv) none of the limited partners were officers or directors of the Society.<sup>119</sup>

As a result of the *Plumstead* decision, the IRS abandoned its *per se* position that an exempt organization's participation as a general partner in a joint venture adversely affected its tax-exempt status,<sup>120</sup> and adopted a "two-prong test" for analyzing whether such participation jeopardized tax-exempt status.<sup>121</sup> In GCM 39,005, the exempt organization was one of several general partners in a limited partnership formed to construct, own, and operate a living facility for low-income elderly and handicapped individuals.<sup>122</sup> In determining whether the organization's tax-exempt status was jeopardized by virtue of its participation in the limited partnership, the IRS Chief Counsel concluded that such participation did not jeopardize the organization's tax exemption because its participation in the joint venture furthered its exempt purposes. In addition, the IRS determined that the structure of the partnership agreement, together with federally-imposed restrictions, sufficiently ensured that its partnership obligations would not conflict with its exempt purposes.

In reaching its conclusion in GCM 39,005, the IRS Chief Counsel enunciated a two-part standard for analyzing an exempt organization's participation in a joint venture: (i) Whether the exempt organization's participation in the joint venture serves or furthers its exempt purpose (sometimes referred to as the "charitable purpose test"<sup>123</sup>); and (ii) whether the partnership agreement permits the organization to operate exclusively for exempt purposes and results in not more than incidental private benefit to the for-profit, limited partners (sometimes referred to as the "private benefit test"<sup>124</sup>).<sup>125</sup> The first prong of the test is, in essence, an extension of the operational test under Section 501(c)(3)—taking into consideration the exempt organization's participa-

<sup>118</sup> *Id.* at 1328.

<sup>119</sup> *Id.* at 1333-34.

<sup>120</sup> SANDERS, *supra* note 6, § 4.2, at 122.

<sup>121</sup> See I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983), available at 1983 IRS GCM LEXIS 56; see also I.R.S. Gen. Couns. Mem. 39,732 (May 27, 1988), available at 1988 IRS GCM LEXIS 44.

<sup>122</sup> I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983).

<sup>123</sup> Korman & Balsam, *supra* note 35, at 442.

<sup>124</sup> *Id.*

<sup>125</sup> Salins, et al., *supra* note 35, at 2.

tion in the joint venture and whether the organization is still operated "exclusively" (or "primarily" pursuant to the regulations<sup>126</sup>) for its exempt purposes.<sup>127</sup> Even if a joint venture arrangement furthers an organization's exempt purposes, the second prong of the test focuses the inquiry on the potential conflicts that invariably arise between such exempt purposes and the limited partnership arrangement.<sup>128</sup> Accordingly, while identifying the statutory and other obligations of a general partner, the IRS further acknowledges in the GCM that a partnership agreement may be structured to avoid any such conflicts.<sup>129</sup>

Subsequent general counsel memoranda further clarified and expanded the two-prong test enunciated in GCM 39,005. For instance, in GCM 39,546,<sup>130</sup> the IRS Chief Counsel concluded that an exempt organization, acting as the sole general partner, could fulfill its fiduciary duty of profit maximization to the limited partners while concurrently satisfying the constraints of the Section 501(c)(3) operational test.<sup>131</sup> In addition, the IRS acknowledged that a

<sup>126</sup> See *supra* notes 46-47 and accompanying text.

<sup>127</sup> See SANDERS, *supra* note 6, § 4.2, at 125; *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945) (finding that a single substantial non-exempt purpose can obliterate an organization's tax exemption, notwithstanding evidence of other charitable or exempt purposes).

<sup>128</sup> SANDERS, *supra* note 6, § 4.2, at 124. As explained by Sanders, such conflicts can arise because of certain statutory obligations and/or obligations arising out of the partnership agreement that are imposed on the exempt organization as a general partner (i.e., assumption of liabilities by the general partner, thereby subjecting its personal assets-potential risk for satisfying partnership debts; profit motive of limited partners). *Id.* However, as he discusses, the partnership agreement can be structured to prevent certain conflicts of interest from arising. *Id.* See also *supra* note 114 and accompanying text.

<sup>129</sup> Korman & Balsam, *supra* note 35, at 442-43. The authors note that, in subsequent rulings and guidance, the IRS examines other protections available to an exempt general partner in joint ventures: (i) allocations based on capital contributions and assumed risks, I.R.S. Gen. Couns. Mem. 39,732 (May 27, 1988), available at 1988 IRS GCM LEXIS 44; (ii) no special allocations of income, loss or deductions to any partner, *id.*; (iii) services and property provided or contributed to the partnership must be at fair market value, *id.*; (iv) capital contributions by limited partners must be substantial, I.R.S. Gen. Couns. Mem. 39,862 (Nov. 21, 1991), available at 1991 IRS GCM LEXIS 39; and (v) reasonable compensation to all officers, directors and partners of a joint venture, *Plumstead Theatre Society v. Comm'r*, 74 T.C. 1324, 1333 (1980); *Priv. Ltr. Rul.* 89-17-055 (Jan. 3, 1989).

<sup>130</sup> I.R.S. Gen. Couns. Mem. 39,546 (Aug. 25, 1986), available at 1986 IRS GCM LEXIS 83.

<sup>131</sup> *Id.* The GCM specifically states, "Although there is likely to be tension in any arrangement in which an exempt organization has responsibilities to carry on a profit-making activity with non-exempt participants, we believe that the case law and our administrative practice allow exempt organizations to be general partners. Of course, it is a highly factual area and each case must be carefully scrutinized." *Id.* See also I.R.S. Gen. Couns. Mem. 39,732, which addresses three tax-exempt hospitals participating as general partners in joint ventures with for-profit entities to provide certain health care services such as physical therapy, ambulatory surgery and magnetic resonance imaging. The IRS Chief Counsel reached a favorable conclusion as to such joint ventures, stating that such conclusion is consistent with its previously-announced position in I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983), available at 1983 IRS GCM LEXIS 56. Further, the Chief Counsel affirmed such position by stating that "there is nothing per se objectionable with an exempt organization entering into a limited partnership where it either lacks or does not wish to expend all of the funds necessary to build or purchase a facility which will further its exempt purposes." I.R.S. Gen. Couns. Mem. 39,546 further states that the exempt organization is not required to establish that the

tax-exempt general partner could not totally eliminate its liability exposure for partnership debts, an obligation typically imposed by state partnership law and a potential conflict with its exempt purpose.<sup>132</sup> The IRS stated that, "although the exposure of the general partner may be limited through insurance, indemnity agreements, or the nature of the activities carried on by the partnership, we doubt that it can be eliminated."<sup>133</sup> More importantly, as stated by one commentator, GCM 39546 "is significant because it does much to resolve a fundamental problem arising in joint ventures, i.e., that the two or more participants in it may have very different, but nonetheless compatible reasons for forming the joint venture, one to further its exempt purpose and the other to obtain a fair return on the investment."<sup>134</sup>

The principles inherent in the two-prong test of GCM 39,005 were later applied, although not explicitly, in *Housing Pioneers v. Commissioner*.<sup>135</sup> In *Housing Pioneers*, the Tax Court upheld the IRS's determination that a California nonprofit corporation, whose stated purpose was "to provide innovative and affordable housing for low income people, handicapped persons, and pre-and post-incarcerated persons," did not qualify for exemption under Section 501(c)(3) because its primary activity—serving as co-general partner in for-profit limited partnerships that owned and managed low-income housing projects—constituted a substantial non-exempt purpose.<sup>136</sup> As a consequence, the organization was found to primarily serve private rather than public interests.<sup>137</sup>

The Ninth Circuit Court of Appeals concurred with the Tax Court's finding that the nonprofit entered into these partnerships as a one percent co-general partner for the primary purpose of availing all of the partners, both general and limited, of the available federal and California state tax benefits associated with such partnerships' low-income housing activities.<sup>138</sup> Under the management agreement executed as to each limited partnership, the nonprofit's authority as a general partner is "narrowly circumscribed," with no management

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facility could not have been built and operated without its participation in a limited partnership.

<sup>132</sup> I.R.S. Gen. Couns. Mem. 39,546 (stating "Normally, under state law, the general partner will have unlimited liability for partnership debts, other than those that are nonrecourse."). See also *supra* note 128 and accompanying text.

<sup>133</sup> I.R.S. Gen. Couns. Mem. 39,546.

<sup>134</sup> HILL & MANCINO, *supra* note 88, ¶ 29.04[2], at 29-14.

<sup>135</sup> *Housing Pioneers v. Comm'r*, 65 T.C.M. (RIA) 2191, *aff'd*, 49 F.3d 1395 (9th Cir.), *amended*, 58 F.3d 401 (9th Cir. 1995). I.R.S. Gen. Couns. Mem. 39,005 is not explicitly mentioned in either the Tax Court's or the Ninth Circuit's opinions. However, the two-step analysis of I.R.S. Gen. Couns. Mem. 39,005 is implicit in the conclusions reached.

<sup>136</sup> *Housing Pioneers*, 65 T.C.M. at 2191.

<sup>137</sup> *Housing Pioneers v. Comm'r*, 58 F.3d 401, 402 (citing *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945)). See *supra* notes 68-73 and accompanying text for a discussion of the "private benefit doctrine."

<sup>138</sup> *Housing Pioneers*, 58 F.3d at 404. Specifically, the limited partnership arrangement permitted such partnerships to qualify for low-income housing tax credits under Section 42 and/or California property tax reduction (§ 214(g) of the California Revenue and Taxation Code), a benefit that inured in part to the nonprofit corporation. See SANDERS, *supra* note 6, § 4.2, at 133-34 for a more detailed discussion.

responsibilities.<sup>139</sup> As to one of these agreements, the nonprofit acknowledged to the IRS that it was not negotiated at arm's length due to the interrelationships between members of the nonprofit's board and limited partners in the partnership.<sup>140</sup> Although the Tax Court and the Ninth<sup>3</sup>Circuit did not explicitly apply the two-prong test of GCM 39,005, which has been criticized,<sup>141</sup> their conclusion nevertheless is consistent with the application of such test. The courts found that: (i) The nonprofit's participation in the limited partnerships did not further its exempt purpose (the first prong or charitable purpose test); and (ii) the limited partnership arrangement failed to protect or "insulate" the nonprofit from conflicts between its obligations as a general partner and its exempt purpose (the second prong or private benefit test).<sup>142</sup>

*b. Emergence of a "Control" Standard and Revenue Ruling 98-15*

In evaluating joint ventures between exempt organizations and for-profit entities, the focus of the IRS in applying the two-prong test of GCM 39,005 began to center on whether the exempt organization had sufficient "control" over the joint venture entity. In Private Letter Ruling 9637050,<sup>143</sup> the taxpayer seeking the ruling was an acute health care facility exempt under Section 501(c)(3). The taxpayer and another tax-exempt health care organization, which operated hospitals, were offered an opportunity to purchase a thirty-seven and one-half percent and a twenty-five percent interest, respectively, in a limited liability company ("LLC") owned by three physicians, none of whom were officers or directors of the two exempt health care organizations.<sup>144</sup>

The LLC proposed to construct and operate a new dialysis center. To date, the taxpayer had owned and operated the only outpatient and inpatient dialysis center facility in the area in which it was located and had been investigating the need for a new facility because its present facility was antiquated and failed to meet the need for such services in the area.<sup>145</sup> The taxpayer planned to enter into a Joint Venture Agreement ("Agreement") with the LLC with respect to the operation of the LLC's dialysis center. Pursuant to the Agreement, capital contributions to the LLC, allocations of profits and losses, and any distributions to members would be proportionate to the members' respective interests. In addition, members would be liable for LLC debts and liabili-

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<sup>139</sup> *Housing Pioneers*, 65 T.C.M. at 2193.

<sup>140</sup> *Id.* As to one of the limited partnerships, two of the limited partners also served as members of the nonprofit's board of directors. Although the Tax Court's decision was based primarily on the nonprofit's substantial commercial purpose and conference of private benefit, the Court acknowledged the inherent private inurement issue by stating that, "The facts of this case demonstrate how inextricably interwoven a commercial purpose under the operational test and the serving of a private interest under the private inurement test may become. Consequently we need not independently consider the application of the private inurement test to the facts of this case." *Id.* at 2196.

<sup>141</sup> HILL & MANCINO, *supra* note 88, ¶ 29.04[4], at 29-21.

<sup>142</sup> See I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983), available at 1983 IRS GCM LEXIS 56.

<sup>143</sup> I.R.S. Priv. Ltr. Rul. 96-37-050 (June 18, 1996).

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

ties in proportion to their interests.<sup>146</sup> All such financial such financial arrangements with the physician members would be negotiated at arm's length and based on fair market value. The taxpayer and other exempt health care organization, who combined would hold sixty-two and one-half percent of the membership interest in the LLC, would elect five of the eight members of the LLC's Board of Managers.<sup>147</sup>

In concluding that participation in the joint venture would not adversely affect the taxpayer's exempt status, the IRS explained:

The control you [the taxpayer] and . . . [the other exempt health care organization] will exercise by electing the majority of the members of the Board of Managers of LLC will ensure that exempt organizations retain control of the LLC Dialysis Center's operations and will ensure that medical services will be available to anyone in the community who needs them, regardless of ability to pay. Thus, your ownership interest in LLC will enable you to promote health in a charitable manner.<sup>148</sup>

In addition, the IRS found that the taxpayer's participation in the proposed joint venture furthered, and was related to, its charitable purposes and, thus, was not subject to UBIT under Section 513(a).<sup>149</sup>

Revenue Ruling 98-15,<sup>150</sup> issued in 1998, was the first guidance with precedential value promulgated by the IRS with respect to joint ventures between exempt organizations and for-profit participants.<sup>151</sup> The revenue ruling was issued in response to the "rapid increase and magnitude of nonprofit, exempt hospitals entering into joint venture arrangements with for-profit entities, in particular, the whole hospital joint venture arrangement."<sup>152</sup> The revenue ruling provided guidance in the context of two factual scenarios or "situations," each of which has differing results as to the organization's tax-exempt status. In both situations, an exempt organization that operated an acute care hospital was in need of additional funding to better serve its community and, as a consequence, participated in a joint venture (a limited liability company ("LLC") taxed as a partnership for federal income tax purposes) with an unrelated, for-profit corporation.<sup>153</sup> In exchange for its LLC membership interest, the exempt organization contributed the hospital and all of its operating assets to the LLC (i.e., a whole hospital joint venture). The for-profit entity also contributed assets to the LLC in exchange for its LLC membership inter-

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<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*; see also I.R.S. Priv. Ltr. Rul. 97-36-039 (June 9, 1997) (The issue of control is central to the ruling that the exempt organization member of a low-income housing limited partnership, upon amending the partnership agreement, gain substantive control over the partnership resources to cause the partnership to comply with the various low-income housing tax credit and other requirements and, thereby, further the exempt organization's purposes.).

<sup>149</sup> I.R.S. Priv. Ltr. Rul. 96-37-050 (June 18, 1996).

<sup>150</sup> Rev. Rul. 98-15, 1998-1 C.B. 718.

<sup>151</sup> Korman & Balsam, *supra* note 35, at 445.

<sup>152</sup> Salins, et al., *supra* note 35, at 1. See also *supra* notes 34-36 and accompanying text. Although the revenue ruling specifically addresses joint ventures between tax-exempt and for-profit health care organizations, the guidance issued therein is equally applicable to joint ventures outside of the health care arena.

<sup>153</sup> Salins, et al., *supra* note 35, at 2.

est. The membership interests received were proportionate to the fair market value of each member's respective contributions.<sup>154</sup>

Based on *Plumstead* and *Housing Pioneers*, Revenue Ruling 98-15 adopted the two-prong test set forth in GCM 39,005.<sup>155</sup> The ruling further provided that an exempt organization may enter into a management agreement with a third party permitting that party to act on behalf of the organization and have direct use of the organization's assets provided that the organization retain ultimate authority over the assets and activities being managed and the terms and conditions of the contract were reasonable.<sup>156</sup> However, if the exempt organization allowed that third party to control or use its activities or assets for its own private benefit, and such benefit was "not incidental to the accomplishment of exempt purposes," the organization failed the organizational and operational tests of Section 501(c)(3).<sup>157</sup>

In applying the two-prong test of GCM 39,005, the revenue ruling attributes the activities of an LLC (treated as a partnership for federal income tax purposes) to its exempt organization owner for purposes of evaluating whether the exempt organization met the operational test of Section 501(c)(3).<sup>158</sup> As applied to partnerships, the UBIT rules under Section 512(c) also attributes an LLC's activities to its exempt organization owner.<sup>159</sup>

The revenue ruling applied the above standards to two factual "situations." In Situation 1, the nonprofit hospital retained its tax-exempt status because it continued to operate exclusively for a charitable purpose and only incidentally for the private benefit of the for-profit member of the LLC.<sup>160</sup> Three of the five members of the LLC's governing board were chosen by the exempt hospital, and two were chosen by the for-profit corporation.<sup>161</sup> A majority of the board (i.e., three members) must approve certain major decisions relating to the LLC's operations including its annual capital and operating budgets, distribution of earnings, selection of key executives, changes to the type of services offered by the hospital, and renewal or termination of management agreements.<sup>162</sup> In addition, the governing documents (i) required the LLC to operate all of its hospital, including any hospital contributed by the for-profit member, in a manner that furthers charitable purposes by promoting health of a broad section of the community, and (ii) explicitly provided that the duty of the LLC directors to operate the LLC in a manner that furthers charitable purposes overrode any duty they may have to operate the LLC for the financial benefit of its

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<sup>154</sup> *Id.*

<sup>155</sup> See Rev. Rul. 98-15, 1998-1 C.B. 718.

<sup>156</sup> See, e.g., *Broadway Theatre League of Lynchburg, Virginia, Inc. v. United States*, 293 F. Supp. 346 (W.D. Va. 1968).

<sup>157</sup> Rev. Rul. 98-15, 1998-1 C.B. 718, 721.

<sup>158</sup> *Id.*

<sup>159</sup> Section 512(c) provides that an exempt organization that is a partner in a partnership which conducts an unrelated trade or business with respect to its exempt activities, must include its distributive share of the partnership's income less deductions in computing its unrelated business income. I.R.C. § 512(c) (2004); Treas. Reg. § 1.512(c)-1 (1958).

<sup>160</sup> Rev. Rul. 98-15, 1998-1 C.B. 1718.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

members.<sup>163</sup> Finally, under the facts of Situation 1, the management company with whom the LLC had a contract was unrelated to either member of the LLC, such contract renewable for additional five-year periods by consent of both parties to the agreement and terminable by the LLC for cause.<sup>164</sup>

In contrast, in Situation 2, the joint venture was held to adversely affect the nonprofit hospital's tax-exempt status because the hospital failed to establish that it will operate exclusively for exempt purposes after it contributes its operating assets to the LLC.<sup>165</sup> The governing documents authorized each member of the LLC to select three representatives to the governing board, with a majority required to approve certain major decisions relating to the LLC's operations including the capital and operating budgets, distributions of earnings over a required minimum level specified in the operating agreement, unusually large contracts, and selection of key executives.<sup>166</sup> The governing documents provided that the organization's purpose was to "construct, develop, own, manage, operate, and take other action in connection with operating the health care facilities it own[ed] and engage[d] in other health care-related activities."<sup>167</sup> There was no reference to charitable activities among the stated purposes. The management company was related to the for-profit member of the LLC and its contract was renewable for five year periods at the sole discretion of the manager, and could be terminated by the LLC for cause.<sup>168</sup> In addition, the chief executive officer and chief financial officer of the LLC, both of whom had previously worked for the for-profit member, and the management company would oversee the day-to-day management of the LLC.<sup>169</sup>

Based on substantial scrutiny of the revenue ruling after its release, several conclusions can be drawn. First, the revenue ruling permits exempt organizations to participate in a joint venture, such as an LLC, and not automatically jeopardize its tax-exempt status.<sup>170</sup> Second, in such situations, the LLC operating agreement should clearly provide that its charitable purposes supersede any financial or private concerns in the event of a conflict between those goals.<sup>171</sup> In addition, all contracts and agreements between the joint venture and another for-profit entity, such as a management agreement, must be entered into at arm's length and reflect commercially reasonable terms.<sup>172</sup> Finally, the revenue ruling clearly favors the numerical control of the joint venture's governing board of directors or trustees by the exempt organization and "elevates" this component to unprecedented importance.<sup>173</sup>

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<sup>163</sup> *Id.*; see also Rev. Rul. 69-545, 1969-2 C.B. 117 (addressing the "community benefit" standard applicable to tax-exempt hospitals).

<sup>164</sup> Rev. Rul. 98-15, 1998-1 C.B. 1718.

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> Korman & Balsam, *supra* note 35, at 447.

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* Korman and Balsam conclude that the control requirement, which was considered in *Housing Pioneers v. Comm'r*, 65 T.C.M. 2191, *aff'd*, 49 F.3d 1395, 1396-97 (9th Cir. 1995), and in *Est of Hawaii v. Comm'r*, 71 T.C. 1067, 1080 (1979), *aff'd in unpublished opinion*,

The revenue ruling also left open many issues, including whether the factors it considered important in reaching a favorable conclusion in Situation 1, specifically the control factor, must be present in all joint ventures involving exempt organizations, including *ancillary* joint ventures. As reflected in the court decisions and administrative rulings issued subsequent to Revenue Ruling 98-15, the control requirement remains in the forefront of any analysis of the federal income treatment of joint ventures, both whole entity and ancillary, involving exempt organizations.<sup>174</sup>

### c. Courts' Application of the "Control" Standard

In *Redlands Surgical Services v. Commissioner*,<sup>175</sup> the Tax Court adopted part of the IRS's reasoning in Revenue Ruling 98-15; specifically, the concept that the exempt organization should have control over the joint venture's activities and operations.<sup>176</sup> Redlands Surgical Services ("RSS") is a corporate subsidiary of Redlands Health Systems, Inc. ("RHS"), an organization tax-exempt under Section 501(c)(3).<sup>177</sup> Redlands-SCA Surgery Centers, Inc. ("SCA Centers") is a wholly-owned, for-profit subsidiary of Surgical Care Affiliates, Inc., a publicly-held corporation specializing in owning and managing ambulatory

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647 F.2d 170 (9th Cir. 1981), and cited in the revenue ruling, was one of many influential factors considered by the courts in those cases. However, Rev. Rul. 98-15, 1998-1 C.B. 718, in the authors' estimation, "elevated the control factor beyond the actual language" of those cases. However, the IRS states that:

Rev. Rul. 98-15 does not say that the tax-exempt entity *must* own the majority interest and control the joint venture's governing board to remain exempt under I.R.C. 501(c)(3). However, majority control by the tax-exempt partner is one of the most important favorable factors in establishing that profit motives do not subvert the charitable mission. *If the tax-exempt entity lacks majority representation or vote on the board to ensure it controls major decisions, it must have another mechanism to ensure the joint venture will operate to further the exempt organization's charitable purposes.*

See Lawrence M. Brauer, et al., *Update on Health Care*, IRS CPE MATERIALS FOR FY 2002, at 161 (emphasis added), available at <http://www.irs.ustreas.gov/charities/article/0,,id=96421,00.html>.

<sup>174</sup> See *infra* notes 175-216 and accompanying text. See also Flynn, *infra* note 176, at 244 (raising the issue of the IRS's application of its "control" analysis to ancillary joint ventures in which exempt health care entities, in particular, tend to participate).

It has been acknowledged that at some point along the continuum of possible tax consequences the nature of the inquiry changes from one of jeopardy to exempt status to an unrelated business income tax (UBIT) analysis under I.R.C. § 512(c) (2004). No offer has been made, however, to draw that line precisely, and the responses from IRS representatives frequently included statements that those interested should pay careful attention to the [then] anticipated decision of the Tax Court in *Redlands*.

*Id.*

<sup>175</sup> *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001). See *infra* note 184 regarding the Ninth Circuit's adoption of the Tax Court's holding in *Redlands*.

<sup>176</sup> The Tax Court's opinion in *Redlands* does not explicitly refer to, or rely upon, Rev. Rul. 98-15, 1998-1 C.B. 718, as authority since the case was pending before the court when the revenue ruling was released by the IRS. See David M. Flynn, *Tax Court's Decision in Redlands Provided Limited Endorsement for IRS Position on Joint Ventures*, \_\_ J. TAX'N 241 (October 1999).

<sup>177</sup> *Redlands*, 113 T.C. at 48.



surgical centers.<sup>178</sup> In 1990, RHS became co-general partner with SCA Centers in a general partnership formed to acquire a sixty-one percent majority interest in an existing outpatient surgical center, Inlands Surgery Center, L.P. (“Surgery Center”).<sup>179</sup> The partnership between RHS and SCA Centers is known as Redlands Ambulatory Surgery Center (“RASC”).<sup>180</sup> SCA Management, a for-profit affiliate of SCA Centers, managed the day-to-day activities of the Surgery Center under a fifteen-year management agreement with a management fee based on a percentage of gross revenues.<sup>181</sup> RHS formed RSS to succeed to its partnership interest as co-general partner; its sole purpose and activity is to hold the partnership interest in, and help govern, RASC as the controlling general partner of the Surgery Center.<sup>182</sup>

RSS filed for recognition of exemption with the IRS. The IRS subsequently issued a final adverse determination, and RSS filed for a declaratory judgment on its exempt status pursuant to Section 7428.<sup>183</sup> The Tax Court rejected RSS’s arguments that it had retained control over RASC and concluded that RSS had “ceded effective control” over the partnership’s activities, conferring a “significant private benefit” on its for-profit partner, SCA Centers, and therefore failed the operational test under Section 501(c)(3).<sup>184</sup> The Tax Court determined that nothing in the partnership agreement or in any other binding commitments relating to the Surgery Center’s operations “establishe[d] any obligation that charitable purposes be put ahead of economic objectives in the Surgery Center’s operations.”<sup>185</sup> Furthermore, the court concluded that RSS’s ability to veto expansion of the Surgery Center’s operations did not establish its “effective control over the manner in which the Surgery Center conducts activities”<sup>186</sup> and, thus, was not enough to ensure the predominance of charitable purposes within the venture.

In reaching its conclusion that RSS failed to establish that it satisfied the operational test under Section 501(c)(3), the Tax Court considered the following five factors: (i) a “lack of any express or implied obligation” of the for-profit parties involved in the partnership to place charitable objectives ahead of noncharitable ones; (ii) RSS’s “lack of voting control” over the partnership; (iii) RSS’s “lack of other formal or informal control sufficient to ensure furtherance of charitable purposes;” (iv) the long-term management contract granting SCA Management “control over the day-to-day operations” and an incentive to

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<sup>178</sup> *Id.* at 50.

<sup>179</sup> *Id.* at 48.

<sup>180</sup> *Id.* at 49-50.

<sup>181</sup> *Id.* at 59-61.

<sup>182</sup> *Id.* at 64.

<sup>183</sup> *Id.* at 48, 70.

<sup>184</sup> *Id.* at 77-78. The Ninth Circuit adopted the Tax Court’s holding without additional discussion, concluding that Redlands Surgical Services “has ceded effective control over the operations of the partners and the Surgery Center to private parties, conferring impermissible private benefit.” *Redlands Surgical Servs. v. Comm’r*, 242 F.3d 904, 904 (9th Cir. 2001) (per curium).

<sup>185</sup> *Redlands*, 113 T.C. at 78-79.

<sup>186</sup> *Id.* at 79-80. The Tax Court further noted that RSS’s veto power similarly did not necessarily indicate that the Surgery Center was not operated to “maximize profits” with respect to its activities. *Id.* at 80.

maximize profits; and (v) the market advantages secured by the SCA affiliates as a result of their arrangements with RSS.<sup>187</sup>

Although the Tax Court clearly viewed RSS's overall lack of control as persuasive in reaching its final conclusion, the court specifically stated that it did not "view any one factor as crucial."<sup>188</sup> This statement led some commentators to view *Redlands* as not being a complete endorsement of the IRS's position in Revenue Ruling 98-15.<sup>189</sup> Furthermore, other "bad" facts in *Redlands*, such as lack of charity care and provision of services to Medicaid patients, dissipated the overall importance of the control factor in the final decision of the Tax Court.<sup>190</sup> Yet, despite the Tax Court's adoption of a more holistic approach in *Redlands*, where control was one of the factors considered, the IRS continued to require such control by the exempt organization, as evidenced in administrative rulings and other cases litigated subsequent to its release.<sup>191</sup>

For example, in *St. David's Health Care System, Inc. v. United States*,<sup>192</sup> the health care system ("St. David's") owned and operated a nonprofit, tax-exempt hospital in Austin, Texas since 1925.<sup>193</sup> In the early 1990s, St. David's determined that it should combine with another health care provider due to the financial difficulties and consolidation occurring in the health care industry.<sup>194</sup> Accordingly, in 1996, St. David's entered into a whole hospital joint venture, by means of a limited partnership, with HCA, Inc. (formerly known as Columbia/HCA Health care Corp.), a for-profit health care provider that already owned several facilities in the Austin suburbs and operated approximately 180 hospitals across the country.<sup>195</sup> The partnership hired Galen Health Care, Inc., a subsidiary of HCA, to manage its daily operations.<sup>196</sup>

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<sup>187</sup> *Id.* at 92-93. In addition, the Tax Court rejected RSS's claim that even if it fails to qualify for tax-exempt status on a "stand alone" basis, it nevertheless qualifies for such status under the "integral part" doctrine. *Id.* at 93-94; *see also* Geisinger Health Plan v. Comm'r, 100 T.C. 394, 403 (1993), *aff'd*, 30 F.3d 494 (3d Cir. 1994), and Treas. Reg. § 1.502-1(b) (as amended in 1970).

<sup>188</sup> *Redlands*, 113 T.C. at 92.

<sup>189</sup> Flynn, *supra* note 176, at 241. In fact, in the author's concluding remarks, he states that voting control "[a]lthough very helpful, it is not absolutely necessary that voting control over management of the joint venture be maintained by the tax-exempt organization in order to achieve this result." *Id.* at 250.

<sup>190</sup> *Redlands*, 113 T.C. at 87-88.

<sup>191</sup> *See supra* note 174 and accompanying text.

<sup>192</sup> *St. David's Health Care Sys., Inc. v. United States*, 2002 WL 1335230 (W.D. Tex. 2002), *vacated by* 349 F.3d 232 (5th Cir. 2003).

<sup>193</sup> *Id.* St. David's was formed as a Texas non-profit corporation in 1925 and recognized the by IRS as tax-exempt under I.R.C. § 501(c)(3) in 1938. *Id.*

<sup>194</sup> *St. David's*, 349 F.3d at 233-34.

<sup>195</sup> *St. David's*, 2002 WL 1335230 at \*1. Pursuant to the joint venture, St. David's contributed all of its hospital and medical assets and HCA contributed all of its hospitals and medical assets located in the Austin, Texas area to the limited partnership. The partnership's two general partners, St. David's and Round Rock Hospital, Inc., a wholly owned subsidiary of HCA, each hold a ten percent interest. The two limited partners are St. David's and Columbia/SDH Holding, a wholly-owned subsidiary of HCA. St. David's combined ownership interest (as both a general and limited partner) is 45.9%, with the remaining 54.1% ownership interest held by HCA-affiliated entities. *Id.*

<sup>196</sup> *St. David's*, 349 F.3d at 234.

In 1998, the IRS audited St. David's and determined that it no longer qualified for exemption under Section 501(c)(3) due to its participation in the partnership and, in October 2000, revoked its exempt status retroactively to the date of its entry into the partnership in 1996.<sup>197</sup> In response to this revocation, St. David's paid the requisite taxes owed and filed a refund suit in the United States District Court for the Western District of Texas.<sup>198</sup> Upon considering the summary judgment motions filed by both parties, the District Court granted the motion filed by St. David's on the issue of its tax-exempt status for the 1996 taxable year and further ordered the payment of attorney's fees by the government.<sup>199</sup>

Upon appeal, the United States Court of Appeals for the Fifth Circuit vacated the District Court's summary judgment ruling and award of attorney's fees, and remanded the case for further proceedings.<sup>200</sup> Relying on Revenue Ruling 98-15 and *Redlands*, the Fifth Circuit focused on the issue of St. David's control over the joint venture, ultimately concluding that genuine issues of material fact existed with respect to whether St. David's "ceded control" of its tax-exempt hospital to HCA.<sup>201</sup> In analyzing the issue of control, the Fifth Circuit found that, although St. David's appointed one-half of the partnership's Board of Governors (HCA appointing the other half) and possessed effective veto power over any proposed Board action,<sup>202</sup> its lack of majority voting control effectively meant that it could not "initiate action" without the support of HCA.<sup>203</sup> The court concluded, "Thus, at best, St. David's can prevent the partnership from taking action that might undermine its goals; St. David's cannot necessarily ensure that the partnership will take new action that furthers its charitable purposes."<sup>204</sup>

Although it recognized St. David's continued track record of providing charity care, the Fifth Circuit nevertheless concluded that, given the extremely long duration of its management contract with the limited partnership,<sup>205</sup> the management company, an HCA subsidiary, had no incentive to give any sus-

<sup>197</sup> *St. David's*, 2002 WL 1335230 at \*1.

<sup>198</sup> *St. David's*, 349 F.3d at 234.

<sup>199</sup> *Id.* The District Court determined that the government's position was "not substantially justified," and therefore attorney's fees and other litigation costs totaling \$951,569.83 should be paid to St. David's. *Id.*

<sup>200</sup> *Id.* at 244.

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* at 241 (citing Section 1.8 of the Partnership Agreement). Under such agreement, no measure can pass without a majority of the Board representatives of both St. David's and HCA, thereby giving St. David's the ability to effectively veto any proposed action of the Board. *Id.*

<sup>203</sup> *Id.* The Fifth Circuit similarly rejected St. David's contention that its authority to appoint the Board chairman provided it with a significant amount of control over the Board, finding again that under Section 8.4(c) of the Partnership Agreement no member of the Board possesses the authority to act solely on behalf of the Board. *Id.* at 242 n.12.

<sup>204</sup> *Id.* at 242 (citing *Redlands Surgical Servs. V. Comm'r*, 113 T.C. 47, 79-80 (1999)). "[T]he non-profit did not have sufficient control in part because the non-profit could only veto partnership action; the non-profit could not initiate action without the consent of the for-profit entity." *Id.*

<sup>205</sup> The Management Services Agreement states that Galen will retain its position until 2050, provided that an HCA affiliate remains a general partner of the partnership. *Id.* at n. 13.

tained priority to such charitable interests in operating the hospitals owned by the limited partnership.<sup>206</sup> Finally, the Fifth Circuit gave little effect to St. David's argument that it could utilize the threat of dissolution to cause the partnership to give priority to charitable concerns.<sup>207</sup> In conclusion, although St. David's (and the District Court) considered the above factors along with continued charity care by the hospital after its ownership by the joint venture as providing the necessary protection and furtherance of its charitable purposes, the Fifth Circuit ultimately still wanted to see majority control by the exempt organization.<sup>208</sup>

The IRS praised the Fifth Circuit's decision in *St. David's*, while practitioners viewed the decision as creating a *per se* standard—if control, namely majority voting control, is ceded by an exempt organization in a joint venture with a for-profit entity, more than incidental private benefit is deemed to exist.<sup>209</sup> Furthermore, practitioners did not view the Fifth Circuit's decision as solely applicable to the health care sector of the exempt organization community, thus giving it broad application to all joint ventures entered into by exempt organizations.<sup>210</sup> As discussed below, the court's decision raised the additional issue of whether such a control standard should be equally applied to ancillary joint ventures.<sup>211</sup>

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<sup>206</sup> *Id.* at 242 (citing *Redlands*, 113 T.C. at 83-84).

[T]his long-term management contract with an affiliate of [the for-profit entity] is a salient indicator of [the non-profit's surrender of effective control over the [partnership's] operations"). The Fifth Circuit was also concerned by the fact that a portion of Galen's fee (1%) is computed based on the partnership's net revenues, thereby providing Galen "an incentive-maximize revenues, and to neglect charitable goals.

*Id.* at n.13.

<sup>207</sup> *St. David's*, 349 F.3d at 243-244. The Fifth Circuit noted that (i) Partnership Agreement appeared to permit St. David's to request dissolution only upon a change in the law, and (ii) the existence of a non-compete clause in the Agreement would effectively prevent St. David's from operating in, and serving, the Austin community for two years after dissolution. *Id.*

<sup>208</sup> See Fred Stokeld, *Fifth Circuit Cites Control Issues in Granting IRS Win in St. David's Joint Venture Case*, 42 EXEMPT ORG. TAX. REV. 337, 338 (2003). In the article, Professor Darryll K. Jones commented that the Fifth Circuit's decision was a "big victory" for the IRS. "It successfully eliminated St. David's strongest and most convincing argument, that actual charitable operations make up for a failure of formal control by the charitable partner. The Fifth Circuit has simply stated that the post-formation activities are irrelevant in the absence of formal organizational control." *Id.*

<sup>209</sup> See Fred Stokeld, *EO Community Ponders Meaning of St. David's Holding*, 101 TAX NOTES, Dec. 1, 2003, at 1069 (comments of James R. King, Esq.). In contrast, Don Spellman, Esq., Senior Counsel, IRS Office of Chief Counsel, Tax Exempt/Government Entities, stated that the Fifth Circuit "did what we thought was a proper analysis and we would suggest that the district court opinion is more the aberration." *Id.* at 1068. See also Stokeld, *supra* note 208, at 338. In that Article, Gerald M. Griffith, Esq., stated:

Having the ability to assure that the joint venture does no harm is not enough. What the Fifth Circuit is looking for in *St. David's*, what the Tax Court and Ninth Circuit looked for in *Redlands*, and what the IRS looked for in Revenue Ruling 98-15 is the ability to cause the joint venture to do good.

*Id.* at 338.

<sup>210</sup> Stokeld, *supra* note 209, at 1069 (comments of James R. King, Esq.).

<sup>211</sup> See *infra* note 237 and accompanying text.

However, the St. David's story did not end with the Fifth Circuit's controversial decision. On remand to determine the factual issue of whether St. David's ceded control to HCA, a federal jury decided on March 4, 2004, that St. David's should retain its tax-exempt status despite its participation in the whole entity joint venture with HCA.<sup>212</sup> The jury decision does not, however, signal a defeat of the IRS's control stance with respect to joint ventures. Rather, it is viewed as a win-win outcome for both parties in the case—St. David's retained its tax-exempt status and the IRS earned a precedential decision adopting its control standard set forth in Revenue Ruling 98-15.<sup>213</sup> The IRS continues to view its position, as supported by the Fifth Circuit decision, as the "proper framework" for analyzing joint ventures between exempt organizations and for-profit entities.<sup>214</sup> Although the IRS did preserve its right to appeal the jury verdict by filing a notice of appeal with the Fifth Circuit,<sup>215</sup> it ultimately withdrew its appeal in exchange for St. David's agreement not to seek attorneys' fees in the case.<sup>216</sup>

#### 4. Current Federal Income Tax Law Governing Ancillary Joint Ventures

##### a. Historical Overview

A review of the early rulings and case law with respect to an exempt organization's participation in a joint venture with a for-profit entity, such as *Plumstead*, *Housing Pioneers* and GCM 39,005, reveals that such ventures constitute ancillary, rather than whole entity, ventures.<sup>217</sup> In fact, the distinction between ancillary and whole entity joint ventures did not occur until the early 1990s when the health care industry, in response to its financial and other needs, began entering into whole hospital joint ventures.<sup>218</sup> Nevertheless, even prior to Revenue Ruling 98-15, which was issued in response to such whole hospital joint ventures, the IRS routinely blessed, via private letter rulings,

<sup>212</sup> *St. David's Health Care Sys., Inc., v. United States*, 2002 WL 555095 (W.D. Tex. 2004). The jury rendered its verdict of "We do" in response to a single jury interrogatory: "Do you find St. David's proved by a preponderance of the evidence that it is entitled to a tax exemption for tax year 1996?" *Id.*

<sup>213</sup> See Susanne Pagano & Peyton M. Sturges, *St. David's Verdict May Signal End to IRS Litigation Over Joint Ventures*, DAILY TAX REP. (BNA) No. 47, at G-5 (Mar. 11, 2004).

<sup>214</sup> See Fred Stokeld, *IRS Official Unfazed by Jury Decision in Joint Venture Case*, 2004 TAX NOTES TODAY, Mar. 12, 2004, at 50-5 (comments of Stephanie Caden, Esq., Senior Legal Counsel, IRS Office of Chief Counsel, Tax Exempt/Government Entities, at the Non-Profit Legal & Tax Conference in Washington, D.C. on March 12, 2004) "[T]he Fifth Circuit holding provided the proper framework for judging joint ventures between non-profits and for-profits because the opinion contained guidance making it clear that a non-profit must have effective control in a joint venture. The jury followed that guidance and decided for St. David's . . . ." *Id.*

<sup>215</sup> The IRS filed a notice of appeal on May 13, 2004. See Peyton M. Sturges, *Government Initiates Appeals Process in Texas Hospital Joint Venture Litigation*, DAILY TAX REP. (BNA) May 25, 2004, at G-5.

<sup>216</sup> See Kurt Fernandez & Peyton M. Sturges, *Government, St. David's Agree To Settle Texas Hospital Joint Venture Litigation*, DAILY TAX REP. (BNA), June 14, 2004, at G-1.

<sup>217</sup> See *supra* notes 115-42 and accompanying text.

<sup>218</sup> Korman & Balsam, *supra* note 106, at 445; see also *supra* note 152 and accompanying text.

ancillary joint ventures between exempt hospitals or health care systems and either physicians, other health care providers, or for-profit health care entities (e.g., joint ventures involving ambulatory surgery centers, medical office buildings, various treatment centers, home care services). However, the exempt participant routinely owned a majority interest in the joint venture entity and appointed more than one-half of the members of such entity's governing board.<sup>219</sup> It is the origin of whole hospital joint ventures that appears to have prompted the IRS to formally institute, via Revenue Ruling 98-15, a control standard with respect to an exempt organization's participation in a joint venture with for-profit participants.<sup>220</sup>

*b. Effect of the "Control" Standard on Ancillary Joint Ventures*

As explained above, Revenue Ruling 98-15 explicitly addresses whole hospital or whole entity joint ventures where the exempt organization typically transfers all of its operating assets to a joint venture entity in exchange for a membership interest in the entity.<sup>221</sup> After the release of Revenue Ruling 98-15, it was initially uncertain whether the revenue ruling and its control standard would apply to ancillary joint ventures.<sup>222</sup> Unlike in a whole hospital joint venture, an exempt hospital still remains in existence in an ancillary joint venture<sup>223</sup> and is still subject to the community benefit standard.<sup>224</sup> Accordingly, the analysis of an exempt hospital's participation in an ancillary joint venture should theoretically differ from the whole entity ventures addressed in Revenue Ruling 98-15. Specifically, because an ancillary joint venture may involve the contribution of only an insignificant portion of the exempt organization's total assets, the organization's control over the joint venture is arguably less necessary to ensure that it is accomplishing its exempt purposes and meeting the operation test of Section 501(c)(3).

However, it became clear from the *Redlands* decision, comments made by IRS officials, and administrative rulings issued subsequent to the revenue ruling, that the IRS regarded Revenue Ruling 98-15 and its control standard as equally applicable to ancillary joint ventures.<sup>225</sup> Several of the administrative rulings issued subsequent to the revenue ruling involved joint ventures with other exempt organizations, each of which determined that the joint venture did not jeopardize the exempt status of either organization.<sup>226</sup> Other administrative rulings issued by the IRS involved joint ventures between exempt organizations

<sup>219</sup> See, e.g., I.R.S. Priv. Ltr. Rul. 96-45-018 (Nov. 8, 1996); I.R.S. Priv. Ltr. Rul. 95-17-029 (Jan. 27, 1995).

<sup>220</sup> Korman & Balsam, *supra* note 106, at 445.

<sup>221</sup> See *supra* notes 153-54 and accompanying text.

<sup>222</sup> See SANDERS, *supra* note 6, § 11.3(d)(ix), at 373.

<sup>223</sup> Whereas, in a whole hospital joint venture, the hospital is no longer owned and operated by a tax-exempt entity, but rather a for-profit limited liability company or similar entity. See *supra* note 40 and accompanying text with respect to the community benefit standard applied to nonprofit hospitals pursuant to Rev. Rul. 69-545.

<sup>224</sup> SANDERS, *supra* note 6, § 11.3(d)(ix), at 373.

<sup>225</sup> *Id.* at n.276 (citing comments by Catherine E. Livingston, Associate Tax Counsel, U.S. Treasury Department).

<sup>226</sup> I.R.S. Priv. Ltr. Ruls. 199913035 (Dec. 22, 1998), 200102052 (Oct. 10, 2000), 200117043 (Jan. 30, 2001), and 200218037 (Mar. 27, 2001).

and for-profit participants in which Revenue Ruling 98-15 along with its control standard was applied in full force.<sup>227</sup>

A private letter ruling issued in late 2001 illustrates the IRS's post-Revenue Ruling 98-15 posture as to ancillary joint ventures.<sup>228</sup> This letter ruling reflects IRS's strict adherence to the facts of "Situation 1" of Revenue Ruling 98-15 in issuing a favorable determination with respect to an ancillary joint venture.<sup>229</sup> The joint venture involved the formation of a limited liability company by a tax-exempt hospital and a group of physicians, the purpose of which was to provide, and increase the availability of, a new medical treatment. The hospital contributed the equipment to perform the new treatment to the LLC in exchange for its membership interest and the physicians contributed cash in exchange for theirs, such interests being proportional to the value of their respective contributions.<sup>230</sup>

Under the LLC's operating agreement, allocations of income, loss, deduction, and credits were in proportion to the members' percentage interests. As in Situation 1 of Revenue Ruling 98-15, the tax-exempt hospital appointed a majority of the LLC's five-member board of directors.<sup>231</sup> In addition, the LLC's operating agreement clearly provided that its charitable purposes must override any duty that the board members may have to operate for the financial benefit of the LLC members, with the board lacking the power to initiate any action with respect to the LLC's charity care policy without the direct consent of the exempt hospital.<sup>232</sup> Based on these and other factors, the IRS found that the hospital's participation in the joint venture did not adversely affect, but rather furthered, its exempt purposes and status under Section 501(c)(3).<sup>233</sup>

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<sup>227</sup> I.R.S. Priv. Ltr. Ruls. 200118054 (Feb. 7, 2001), 200206058 (Nov. 16, 2001), and 200304041 (Nov. 1, 2002); Tech. Adv. Mem. 2001-51-045 (July 25, 2001).

<sup>228</sup> I.R.S. Priv. Ltr. Rul. 2002-06-058 (Nov. 16, 2001).

<sup>229</sup> See *Hospital Keeps Tax-Exempt Status in Doctor Joint Venture by Holding Controlling Interest*, 11 HEALTH LAW REP. (BNA) Mar. 7, 2002, at 381 which states that:

The ruling does not reduce the uncertainty that prior IRS guidance on tax treatment of joint ventures between for-profit and non-profit health care entities has left, because the plan fits squarely within the field of activities that the IRS has said are permissible under Revenue Ruling 98-15, according to health care attorneys.

*Id.*

In the Article, Douglas K. Anning, Esq., commented that, "[i]n a certain sense, it [PLR 200206058] is not that illuminating because the facts fit squarely within the facts of Situation 1 of Revenue Ruling 98-15." He further stated that health and tax-exempt law practitioners were really seeking guidance in the "gray area" between what the IRS has ruled as permissible (i.e., Situation 1 of Rev. Rul. 98-15) and what it ruled as not (i.e., Situation 2 of the revenue ruling). *Id.*

<sup>230</sup> I.R.S. Priv. Ltr. Rul. 2002-06-058. The value of the contributed equipment represented only about three percent of the exempt hospital's total assets.

<sup>231</sup> *Id.* The tax-exempt hospital appoints three members (sixty percent) and a majority of the physicians appoint the remaining two members (forty percent) on the board. The hospital's representatives on the board will be comprised of community leaders with experience in health care matters. The operating agreement contains a conflict of interest policy to address any transactions or arrangements between the LLC and its board members. *Id.*

<sup>232</sup> *Id.*

<sup>233</sup> *Id.* For the same reasons, the IRS also found that the hospital's distributive share of the LLC's profits is not subject to UBIT under I.R.C. § 512(c) (2004). *Id.*

The strict adherence of these letter rulings to the tenets of Revenue Ruling 98-15 evoked a common response—a call to action by tax and health law practitioners for the IRS to provide guidance on the “gray areas” that fall between the “good” and “bad” situations discussed in Revenue Ruling 98-15, including ancillary joint ventures.<sup>234</sup> Despite this call to action, in late 2001, the IRS actually announced that it would not issue any private letter rulings with respect to joint ventures, whether whole entity or ancillary, between tax-exempt hospitals and for-profit entities.<sup>235</sup> Some practitioners felt that this announcement was made because the IRS did not want to issue any rulings in the joint venture area that might jeopardize its position in the pending *St. David's* litigation.<sup>236</sup> However, as previously stated, the Fifth Circuit's decision in *St. David's* did little to address the “gray areas” left open by Revenue Ruling 98-15, including the treatment of ancillary joint ventures.<sup>237</sup>

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<sup>234</sup> Barbara Yuill, *No IRS Private Rulings on Way for Charitable Hospital Joint Ventures*, HEALTH LAW REP. (BNA) Dec. 13, 2001, at 1867. In the Article, T.J. Sullivan, Esq., commented that the IRS “needs to adopt a workable position on ancillary joint ventures that don't fit squarely” within the “situations” of Rev. Rul. 98-15. “There are thousands of ancillary joint ventures out there structured before the release of Revenue Ruling 98-15 that are producing income for their tax-exempt participants. No responsible law firm or accounting firm in the country is telling those exempt organizations to report the income as unrelated” to an exempt purpose. He further stated that any “hard line” taken by the IRS in a particular case would likely result in litigation. *Id.* See also *supra* note 229.

<sup>235</sup> Barbara Yuill, *No IRS Private Rulings Expected for Charitable Hospital Joint Ventures*, DAILY TAX REP. (BNA) Dec. 10, 2001, at G-4 (comments of Marvin R. Friedlander, group manager in the IRS's Office of Rulings and Agreements at ALI-ABA Conference on Charitable Organizations). Mr. Friedlander commented that “[w]e [the IRS] are trying to work with exempt organizations to establish some rules in the gray areas.” He further noted that IRS guidance typically travels on a “slow conveyor belt.” *Id.* Almost a year later at the conference for the American Health Lawyers Association, Mr. Friedlander similarly stated that the IRS intended to provide guidance on ancillary joint ventures, but still maintained its position that a nonprofit's control of a joint venture involving a for-profit entity is a “significant factor in ensuring the venture ‘furthers charitable purposes exclusively.’” Peyton M. Sturges, *IRS Officials Outline Ongoing Priorities, Intent to Withdraw 501(m) HMO Guidelines*, HEALTH LAW REP. (BNA), Nov. 7, 2002, at 1589.

<sup>236</sup> See Yuill, *supra* note 234, at 1867 (comments of Jerry R. Peters, Esq.).

<sup>237</sup> Stokeld, *supra* note 208, at 338-39. Gerald M. Griffith commented that the Fifth Circuit's decision in *St. David's*:

[P]uts whole hospital joint ventures in the same limbo state they were in before the district court opinion. It also clouds the waters somewhat on whether the IRS will now take a similarly conservative position on ancillary joint ventures or whether it will continue moving toward treating ancillary joint ventures as raising nothing more than potential unrelated business income issues.

*Id.* at 338-39. In similar comments, T.J. Sullivan advised that the Fifth Circuit's decision did not mean that it was not time to abandon ancillary joint ventures even if it did leave open issues unresolved:

[T]here is at least some possibility that the IRS might adopt guidance down the road that does distinguish between whole hospital and ancillary joint ventures, and [the IRS] might ultimately be convinced that the public is better served by having joint ventures that have at least some charitable aspects to their activities than seeing a wholesale transfer of what could be charitable health care provisions into the taxable sector, where there would be no pressure of public expectation of charity.

Stokeld, *supra* note 209, at 1069.



c. *Proposed Revenue Ruling on Ancillary Joint Ventures*

In early August 2002, the American Bar Association's Health Law Section developed, drafted, and submitted a proposed revenue ruling on ancillary joint ventures to the IRS in an effort to jump start some additional guidance with respect to ancillary joint ventures.<sup>238</sup> The intent of the proposed revenue ruling was to facilitate the use of ancillary joint ventures by exempt health care providers without significant risk of loss of exemption or insistence on business terms undesirable to the for-profit participants in the venture.<sup>239</sup> The drafters of the ruling also hoped that the IRS's adoption of the ruling would "clarify that 'ancillary' situations do not raise exemption issues," but only raise potential UBIT issues.<sup>240</sup> Accordingly, the ruling took the position that the "exemption analysis" of Revenue Ruling 98-15, which focused on the exempt organization's control over the joint venture's operations, was unnecessary in the context of ancillary joint ventures.<sup>241</sup>

The proposed revenue ruling presented two virtually identical situations in which a tax-exempt community hospital and an unrelated, for-profit entity enter into a joint venture, by means of a limited liability company, to own and operate an ambulatory surgery center.<sup>242</sup> In contrast to Revenue Ruling 98-15, the proposed ruling only involved the exempt hospital's transfer of an insubstantial portion of its exempt activities to the venture (thus, an ancillary rather than a whole entity joint venture).<sup>243</sup> The proposed ruling acknowledged that even though the IRS "appears to agree that the tax rules are different for ancillary joint ventures," no precedential guidance with respect to such joint ventures had been issued up to that point.<sup>244</sup> The proposed ruling sought to provide guidance on three major issues: (1) Participation by an exempt organization in an ancillary joint venture does not jeopardize its tax-exempt status, and, therefore, the organization's only tax risk is that its distributive share of the LLC's income may be subject to UBIT; (2) voting control by the exempt organization

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<sup>238</sup> See *ABA Send IRS Proposed Revenue Ruling On Ancillary Joint Ventures*, TAX NOTES TODAY, Oct. 1, 2002, at 190-14 [hereinafter *ABA Proposed Ruling*]; see also William R. Peek, Gordon M. Clay & Susan A. Cobb, *Proposed Joint Venture Examples for Inclusion in Revenue Ruling*, MATERIALS FOR ABA TAX SECTION 2002 MID-YEAR MEETING, available at <http://www.abanet.org/tax/home.html>. The ABA Committee on Exempt Organizations' Task Force on Joint Ventures ("EO Task Force") similarly submitted to the IRS five examples of real-world, non-health care joint ventures between exempt organizations and for-profit entities along with a short analysis of each example. Similar to the proposed revenue ruling submitted by the ABA's Health Law Section, the intent of the EO Task Force's submission was to assist the IRS in providing guidance in the "gray area" created by the release of Revenue Ruling 98-15 (i.e., the factual area lying between the good and bad situations); specifically, ancillary joint ventures. Some of the examples contain facts where the exempt organization possesses less than voting control, which is held to be appropriate under certain circumstances. *Id.*

<sup>239</sup> See J. Christine Harris, *Proposed Revenue Ruling On Ancillary Joint Ventures Much Needed, Say EO Reps*, TAX NOTES, Oct. 9, 2002, at 196-10, available at LEXIS 2005 TNT 196-10.

<sup>240</sup> *Id.* (comments of David M. Flynn).

<sup>241</sup> *Id.*

<sup>242</sup> *ABA Proposed Ruling*, *supra* note 238.

<sup>243</sup> *Id.*

<sup>244</sup> *Id.*

is not as important in an ancillary joint venture as it is in a whole entity joint venture; and (3) the private benefit test is not applicable in determining whether the exempt organization's participation is subject to UBIT.<sup>245</sup>

In both Situations 1 and 2 of the proposed revenue ruling, the LLC was managed by a six-member board of managers, three members of which were selected by the exempt organization and three of which were selected by the for-profit participant. The primary differences between the two scenarios involved the following facts particular to Situation 2: (1) The LLC operating agreement contained no provision requiring the ASC's operations to comply with the community benefit standard of Revenue Ruling 69-545, and did not provide any charity care policy; (2) the management agreement was similarly devoid of any charity care or community benefit requirements, thereby failing to ensure the furtherance of the hospital's exempt purposes; and (3) the business plan approved by the LLC's board of directors emphasized profitability of surgical procedures and a marketing focus on private pay and private insurance patients.<sup>246</sup> In both Situations, the proposed ruling concluded that participation in the ancillary joint ventures did not by itself jeopardize the hospital's exemption under Section 501(c)(3). The proposed ruling held that in Situation 1 the hospital's participation in the joint venture was substantially related to its exempt purposes and, therefore, its distributive share from the venture was not subject to UBIT.<sup>247</sup> In contrast, the participation in the joint venture by the hospital in Situation 2 was held to be unrelated to its exempt status because the hospital could not ensure that the ambulatory surgical center "will be operated in a manner that is substantially related to its exempt purposes." Accordingly, the hospital's distributive share in Situation 2 was subject to UBIT.<sup>248</sup>

Accordingly, the ABA Health Section's proposed revenue ruling on ancillary joint ventures focused its analysis on one essential issue—whether the exempt organization's participation in the joint venture is subject to UBIT.<sup>249</sup> The basis for this focus is that, unlike whole entity joint ventures, only an insubstantial amount of the exempt organization's assets are contributed to the joint venture and, as a result, the exempt organization remains intact with substantial exempt activities separate and apart from those conducted by the joint venture. As discussed in Part III of this Article, a prominent scholar in the exempt organization area consistently advocates this UBIT-focused analysis,<sup>250</sup> which is subject to criticism.<sup>251</sup> Although the IRS did not officially comment on the ABA Health Section's proposed ruling or rush to issue a revenue ruling similar to it,<sup>252</sup> portions of the proposed ruling appear to be adopted in Revenue Ruling 2004-51 issued by the IRS in 2004, as discussed below.

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<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> *Id.*

<sup>248</sup> *Id.*

<sup>249</sup> *Id.*

<sup>250</sup> See *infra* notes 282-92 and accompanying text.

<sup>251</sup> See *infra* notes 302-09 and accompanying text.

<sup>252</sup> See SANDERS, *supra* note 6, Supp. § 4.2(e), at 37. The IRS similarly did not comment on the ancillary joint venture examples submitted by the EO Task Force. *Id.*; see also *supra* note 238.

d. *John Gabriel Ryan Association*

Within several months of the submission of the ABA's proposed revenue ruling on ancillary joint ventures to the IRS, The John Gabriel Ryan Association filed a petition in the United States Tax Court challenging the IRS's denial of its application for tax exemption under Section 501(c)(3).<sup>253</sup> The Association is a health care organization affiliated with Providence Health System, a tax-exempt Catholic health care provider.<sup>254</sup> The Association's sole activity is to participate in five ancillary joint ventures with other health care entities. After almost four years of consideration of the Association's application for tax-exempt status, the IRS issued a final adverse ruling with respect to the Association's request for exemption on the bases that: (i) the Association was not operated exclusively for exempt purposes within the meaning of Section 501(c)(3); and (ii) the Association's activities benefit private interests more than incidentally and, thus, do not exclusively further exempt charitable purposes.<sup>255</sup>

In two of the five joint ventures in which the Association participated, the venture was owned and managed by only exempt organizations.<sup>256</sup> In the third joint venture, the Association served as a co-general partner, owning ninety-nine percent of each venture jointly with its sole corporate member, Providence Health System-Washington, an entity tax-exempt under Section 501(c)(3).<sup>257</sup> In the fourth joint venture, the Association was the sole general partner in a limited partnership that owned, operated and leased a medical office building located next to a tax-exempt hospital.<sup>258</sup> In the fifth joint venture, the Association was a co-general partner with a for-profit entity, each owning a fifty per-

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<sup>253</sup> See *Petition of The John Gabriel Ryan Association*, John Gabriel Ryan Ass'n v. Comm'r, No. 16811-02X (T.C. 2002), reprinted in *U.S. Tax Court Petition in John Gabriel Ryan Association v. Commissioner*, DAILY TAX REPORT: PRIMARY SOURCE MATERIAL: COURT MOTIONS (BNA online), Nov. 6, 2002 (petition filed October 25, 2002).

<sup>254</sup> *Id.* The Association's sole corporate member, Providence Health System-Washington ("PHC-Washington"), is an exempt organization under I.R.C. § 501(c)(3). *Id.*

<sup>255</sup> *Id.*

<sup>256</sup> *Id.* The Association is a co-general partner in Valley Imaging Partners with PHC-Washington, its sole corporate member, and Yakima Valley Memorial Hospital Association, both exempt organizations under I.R.C. § 501(c)(3). Yakima Valley owns a fifty percent interest with Association and PHS-Washington jointly owning the remaining fifty percent interest in the joint venture. *Id.* The Association also serves as a co-general partner in the Tanasbourne Medical Partnership with Tuality Community Hospital, Inc., an exempt organization under I.R.C. § 501(c)(3). *Id.*

<sup>257</sup> *Id.* The Association is a co-general partner in Providence Imaging Center Joint Venture with PHS-Washington and Alaska Medical Imaging, Inc., an Alaska for-profit corporation. *Id.*

<sup>258</sup> *Id.* The Association is the sole general partner of, and owns a fifty percent interest in, the Greater Valley Medical Building Partnership, L.P. Real Med LLC, a California limited liability company, is the limited partner and owns a fifty percent interest in the limited partnership. *Id.* The Association possesses complete authority and control over the management of the limited partnership. *Id.* The medical building is located adjacent to a hospital owned and operated by Providence Health System, a tax-exempt entity with whom Association is affiliated. *Id.*

cent interest in the venture.<sup>259</sup> In light of Revenue Ruling 98-15 and subsequent administrative guidance, it was the structure of this fifth joint venture that appeared to have presented some potential problem to the IRS with respect to the Association's application for exemption. Nevertheless, certain provisions in the joint venture agreement attempted to ensure the furtherance of the Association's exempt charitable purposes, including the promotion of health, and precedence of the venture's charitable activities over its profit motives and goals.<sup>260</sup>

Pursuant to a settlement of the case between the two parties, the IRS issued a favorable determination letter on June 25, 2003 granting the Association tax-exempt status under Section 501(c)(3).<sup>261</sup> The IRS did not articulate the grounds for its determination, but presumably it became comfortable with the fact that the various joint venture and partnership agreements provided some credible and verifiable protections of the Association's charitable purposes other than its majority control of the venture.<sup>262</sup> The settlement of this case was viewed as significant by practitioners in the exempt organizations sector because the IRS implicitly blessed an ancillary joint venture structure, namely the fifth joint venture discussed above, which involved equal board representation and control by both the tax-exempt and for-profit participants but provided safeguards in the joint venture agreement which ensured that the venture operates in furtherance of the exempt participant's charitable purposes.<sup>263</sup> Even though at the time of the settlement the federal district court in the *St. David's* case had already approved a similar fifty-fifty control scenario in a whole hospital joint venture (which was being appealed to the Fifth Cir-

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<sup>259</sup> *Id.* The Association is a co-general partner in Providence St. Peter-South Sound Regional MRI Center ("South Sound") with South Sound Radiologists, Inc., P.S., a Washington professional services corporation. *Id.*

<sup>260</sup> *Id.* See also SANDERS, *supra* note 6, Supp. § 4.2(f.2), at 45. Some of the provisions in the joint venture agreement include:

- (i) South Sound must continuously observe the Ethical and Religious Directives ("ERDs") for Catholic Health Facilities instituted by the National Conference of Catholic Bishops and the United States Catholic Conference;
- (ii) All facilities operated by South Sound must be available on an "open door" policy basis and not deny services to any individuals based on their inability to pay;
- (iii) The Association's right to unilaterally dissolve the joint venture upon notice and its right of first refusal to purchase all or a portion of South Sound's assets upon dissolution; and
- (iv) Certain decisions of the South Sound's Management Committee, including modifying the joint venture agreement or modifying its purposes, must be approved by the Board of Directors of each participant in the joint venture.

*Id.*

In addition, the Association stated in its Tax court petition that South Sound services Medicare and Medicaid patients, provides charity care, and contributes to a local tax-exempt hospital's foundation for charity care and education. *Id.*

<sup>261</sup> Actually, two determination letters were issued by the IRS, both dated June 25, 2003. The first granted the Association its tax-exempt status under I.R.C. § 501(c)(3), effective December 30, 1998, while the second letter granted the Association an exemption under I.R.C. § 501(c)(4) for the period January 1, 1995 through December 30, 1998. See Peyton M. Sturges, *Parties-Dismiss Joint Venture Challenge in Wake of IRS Decision to Grant Exemption*, DAILY TAX REP. (BNA), July 11, 2003, at G-2.

<sup>262</sup> See SANDERS, *supra* note 6, Supp. § 4.2(f.2), at 46.

<sup>263</sup> Sturges, *supra* note 261, at G-2 (comments of T.J. Sullivan).

cuit), the *John Gabriel Association* settlement nevertheless represented the IRS's first approval of such a control structure since its issuance of Revenue Ruling 98-15.<sup>264</sup>

Notwithstanding its importance in revealing a potential change in the IRS's position with respect to ancillary joint ventures, the settlement still did not constitute formal, precedential guidance.<sup>265</sup> The Fifth Circuit's opinion in *St. David's*, released later that year, further clouded the picture with respect to the IRS's treatment of ancillary joint ventures, continuing to leave unaddressed the "gray areas" created by Revenue Ruling 98-15.

*e. IRS's Most Recent Guidance on Ancillary Joint Ventures – Revenue Ruling 2004-51*

In an effort to provide precedential guidance specific to ancillary joint ventures, the IRS recently released Revenue Ruling 2004-51.<sup>266</sup> The facts of the ruling involved a university exempt from federal income tax under Section 501(c)(3), which, as part of its educational programs, offered seminars during the summer to assist elementary and secondary school teachers in further developing and improving their teaching skills. To expand the scope and availability of these seminars, the university entered into a joint venture, by means of an LLC, with a for-profit entity that conducted interactive video training programs.<sup>267</sup> The LLC's governing documents, its Articles of Organization and Operating Agreement, stated that its sole purpose was to "offer teaching training seminars at off-campus locations using interactive video technology."<sup>268</sup> The university and the for-profit member each held a fifty percent membership interest in the LLC, such interests proportionate to the value of their respective capital contributions.<sup>269</sup>

In addition to containing provisions similar to those discussed in prior private letter rulings addressing joint ventures,<sup>270</sup> the LLC's governing documents provided for a six-member governing board, with three directors to be selected by the university and the remaining three by the for-profit member. The content of the seminars conducted by the LLC would mirror the material covered in the university's seminars, the primary difference being that the teachers would participate through the use of an interactive video link from multiple locations, as opposed to one location on the university's campus. Pursuant to the governing documents, the university had the "exclusive right to approve curriculum, training materials, and instructors, and to determine the standards

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<sup>264</sup> *Id.*

<sup>265</sup> See SANDERS, *supra* note 6, Supp. § 4.2(f.2), at 46.

<sup>266</sup> Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

<sup>267</sup> *Id.*

<sup>268</sup> *Id.*

<sup>269</sup> *Id.*

<sup>270</sup> The governing documents require that: (i) all returns of capital, allocation and distributions be made in accordance with each member's ownership interest; and (ii) all contracts and transactions by the LLC be negotiated at arm's length and reflect fair market value for the services or goods received. *Id.*

for successful completion of the seminars.”<sup>271</sup> In addition, the documents mandated that the LLC refrain from engaging in any activities that may jeopardize the university’s exemption under Section 501(c)(3).<sup>272</sup> The ruling specifically stated that the university’s participation in the joint venture constituted an “insubstantial part” of its activities within the meaning of Section 501(c)(3) and applicable regulations thereunder.<sup>273</sup>

The IRS ultimately concluded that because the activities that the university conducted through the LLC did not constitute a substantial part of its overall activities, the university’s participation in the joint venture would not adversely affect its tax-exempt status.<sup>274</sup> In addition, based on facts which establish that the LLC’s activities were substantially related to the exempt purposes and functions of the university, the university’s distributive share of income from the LLC would not be subject to UBIT.<sup>275</sup> In reaching its conclusions, the IRS cited to the Ninth Circuit decision in *Redlands Surgical Services* and the Fifth Circuit decision in *St. David’s*, as well as Revenue Ruling 98-15, but failed to apply them to the facts of the ruling explicitly. Furthermore, there was no specific discussion in the ruling’s analysis regarding the “control” standard of Revenue Ruling 98-15 and its effect, or lack thereof, on the disposition of the ruling. However, under the facts of the ruling, the university did have “exclusive control” over the LLC’s curriculum which was directly related to the university’s exempt educational purposes—a fact that the IRS acknowledged as noteworthy.<sup>276</sup> The ruling also did not directly discuss whether the lack of language in the LLC’s governing documents with respect to the precedence of charitable activities over for-profit motives or goals was significant or not.<sup>277</sup>

*f. State of the Union after Revenue Ruling 2004-51*

Revenue Ruling 2004-51 represents indisputable progress because it is the first instance since Revenue Ruling 98-15 in which the IRS acknowledges and supports equal ownership by the exempt and for-profit participants in a joint venture, provided some protections are in place to ensure the furtherance of the organization’s exempt purposes. Nevertheless, the revenue ruling fails to take additional steps to address ancillary joint ventures that might not meet the IRS’s current standards. For instance, the revenue ruling does not address situations where the exempt participant in an ancillary joint venture possesses less

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<sup>271</sup> *Id.* The for-profit member of the LLC is granted the “exclusive right” to select the locations for participants to interactively link to the seminars and to approve all other personnel necessary to conduct the seminars (e.g., camera operators). *Id.*

<sup>272</sup> *Id.*

<sup>273</sup> *Id.*; see Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990).

<sup>274</sup> Rev. Rul. 2004-51, 2004-22 I.R.B.

<sup>275</sup> *Id.*

<sup>276</sup> See Fred Stokeld, et al., *ABA Tax Section: EO Reps Start Meeting Discussing Rev. Rul. on Ancillary Joint Ventures*, 44 EXEMPT ORG. TAX REV. 273 (2004) (comments of Catherine E. Livingston, IRS Assistant Chief Counsel). Ms. Livingston specifically stated that the regulations defining educational purpose were “an important underpinning to our [the IRS’s] ability to do the guidance.” *Id.*

<sup>277</sup> See Fred Stokeld, *Practitioners Pleased With Revenue Ruling on Ancillary Joint Ventures*, 44 EXEMPT ORG. TAX REV. 284 (2004) (comments of Michael I. Sanders, Esq.).

than fifty percent control on the governing board.<sup>278</sup> Many practitioners have argued that even equal control is not realistic in the current health care market and contend that the IRS is creating an “unrealistic and unattainable standard.”<sup>279</sup> In addition, the ruling does not address situations where the exempt participant does not have “exclusive control” over activities that do relate to its own exempt purposes, or similarly, situations where the activities of the joint venture are not “substantially related” to the exempt participant’s purposes.<sup>280</sup> In response to such unaddressed areas, an IRS representative unofficially issued a poignant reminder—Revenue Ruling 98-15 is “still on the books” and “Revenue Ruling 2004-51 does nothing to modify Revenue Ruling 98-15.”<sup>281</sup> Such comments seem to imply that the “control” standard of Revenue Ruling 98-15 has not been totally disregarded with respect to ancillary joint ventures.

Now that an extensive groundwork has been laid with respect to the evolution of the IRS’s treatment of joint ventures involving exempt organizations and for-profit participants, both whole entity and ancillary, this Article attempts to address whether the IRS’s current “safe” stance, the imposition of a control standard, on ancillary joint ventures is viable. Should a control standard, even the presence of equal control with some procedural safeguards as in Revenue Ruling 2004-51, be instituted with respect to ancillary joint ventures? Or, as advocated by some scholars, should the IRS analysis with respect to ancillary joint ventures be based solely on traditional UBIT principles (to which the IRS eluded, yet failed to definitively adopt, in Revenue Ruling 2004-51)? Or does the IRS already possess the necessary statutory and regulatory resources to address ancillary joint ventures, thus obviating the need for some bright-line standard? Part III of this Article explores various proposals calling for a different analysis with respect to the federal income tax treatment of an exempt organization’s participation in an ancillary joint venture.

### III. EXISTING PROPOSALS FOR THE FEDERAL INCOME TAX TREATMENT OF EXEMPT ORGANIZATIONS’ PARTICIPATION IN ANCILLARY JOINT VENTURES

This is not the first Article to address the federal income tax treatment of joint ventures, ancillary or whole hospital, and to question the viability of the IRS’s reliance on a “control” standard in determining such treatment. As an alternative to the IRS’s control standard, scholars and practitioners in the exempt organizations area have advocated other proposals. Each of these alternative proposals has its strengths and weaknesses, and, therefore, provides valuable insights. Because part of the alternative proposal advocated in this Article builds on two of these proposals, they are explored in greater detail below.

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<sup>278</sup> See generally, Stokeld, *supra* note 276.

<sup>279</sup> See J. Christine Harris, *EO Repts Call IRS’s Stance On Joint Ventures “Unrealistic”*, 98 TAX NOTES, Mar. 24, 2003, at 1816 (comments by Brian Menkes).

<sup>280</sup> See generally, Stokeld, et al., *supra* note 276, at 273.

<sup>281</sup> *Id.* (comments made by Catherine E. Livingston, IRS Assistant Chief Counsel, at the ABA Tax Section Meeting in Washington, D.C., on May 7, 2004).

## A. UBIT Analytical Framework

### 1. Overview

One proposal for analyzing the effect on the tax-exempt status of joint ventures, including ancillary ventures—the UBIT—has been consistently advocated by Professor John Colombo.<sup>282</sup> As Professor Colombo points out, the existence of the UBIT “reinforces the basic rule that an exempt organization can engage in significant business activity that is not in furtherance of a charitable purpose without losing exemption—after all, there would be no reason to tax *unrelated* business activity if that activity caused loss of exemption in the first place.”<sup>283</sup> Based on the statutory and regulatory structure of the UBIT, the Professor has devised an “analytical framework” of four possibilities for evaluating the federal income tax consequences of a business activity or transaction entered into by an exempt organization. First, if the business activity itself is charitable, there is no UBIT issue and no effect on the organization’s tax-exempt status.<sup>284</sup> Second, if the business activity is not itself charitable, but is “substantially related” to the organization’s exempt purposes, the net earnings from the activity are not subject to the UBIT and there is no effect on the organization’s tax-exempt status because the activity is deemed to be “in furtherance of” the organization’s exempt purposes under the UBIT regulations.<sup>285</sup> Third, if the activity or transaction represents an “unrelated” business activity, but is not “substantial” in relation to exempt purposes activities carried on the organization, the net earnings from the activity are subject to the UBIT, but there is no effect on the organization’s tax-exempt status.<sup>286</sup> Finally, if the business activity is unrelated and is substantial in relation to the organization’s exempt activities, the organization may possibly lose its exemption because of its failure to meet operational test of Section 501(c)(3).<sup>287</sup>

Professor Colombo contends that the application of this UBIT analytical framework to joint ventures, both whole entity and ancillary, “helps isolate factors that will be relevant at each analytical stage,” and brings into question the IRS’s current analysis with respect to joint ventures.<sup>288</sup> In applying the analytical framework set forth above, the first issue is whether the joint venture, in and

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<sup>282</sup> See John D. Colombo, *Private Benefit, Joint Ventures, and the Death of Health Care as an Exempt Purpose*, 34 J. HEALTH L. 505 (Fall 2001) [hereinafter, Colombo, *Death of Health Care*]; John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV., Nov. 2001, at 187 [hereinafter, Colombo, *UBIT Framework*]; John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY LAW REV. 487 (2002); and John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 39 EXEMPT ORG. TAX REV. 341 (2003).

<sup>283</sup> Colombo, *UBIT Framework*, *supra* note 282, at 188.

<sup>284</sup> *Id.* An example given by the Professor is the construction and operation of a low-income housing project which would be considered charitable because it “relieves the poor and distressed.” *Id.*

<sup>285</sup> *Id.* at 189 (providing an example of a tax-exempt hospital that operates a pharmacy that sells drugs only to hospital patients).

<sup>286</sup> *Id.* (providing an example of a tax-exempt hospital that operates a pharmacy that sells to both hospital patients and non-patients).

<sup>287</sup> *Id.* See *supra* notes 45-54 and accompanying text for a discussion of the operational test under I.R.C. § 501(c)(3) (2004).

<sup>288</sup> Colombo, *UBIT Framework*, *supra* note 282, at 189.



of itself, constitutes a charitable or otherwise exempt purpose activity with respect to the exempt organization.<sup>289</sup> As to joint ventures entered into by tax-exempt hospitals, the “charitable” nature of the venture’s activities will be determined by whether the “community benefit standard” enunciated in Revenue Ruling 69-545 is met.<sup>290</sup> Likewise, if the joint venture involves a state university, the issue of whether the venture’s activities are “educational” must be resolved by applicable regulations and administrative rulings that address what constitutes an educational activity. In either instance, control of the venture by the exempt organization is *only* a factor in determining whether the venture is charitable or educational.<sup>291</sup> If the venture’s activities are charitable or educational, then category (1) above governs the result. If the joint venture’s activities do not meet the standards for charitable or educational, then category (2) above governs and the issue becomes one of whether the activity is nevertheless “substantially related” to the organization’s exempt purposes, and so on to categories (3) and (4).<sup>292</sup>

In applying the above analytical framework to ancillary joint ventures, the resulting analysis is surprisingly uncomplicated. Because by the very nature of an “ancillary” joint venture an exempt organization is conducting its own charitable or exempt activities other than its participation in the joint venture, Professor Colombo suggests that the resulting analysis focuses on categories (2) and (3) of his proposed framework—whether the activities of the joint venture are “related” to the organization’s exempt purposes.<sup>293</sup> Thus, if deemed related, there would be no threat to the organization’s exempt status and no UBIT consequences (i.e., category (2)). If unrelated, the exempt organization’s distributive share from the venture would be subject to the UBIT, but there still would be no threat to its exempt status (i.e., category (3)).<sup>294</sup> Presumably, category (4) would never apply in the context of an ancillary joint venture provided participation in the venture is truly “ancillary” or insubstantial in comparison to the organization’s exempt activities.<sup>295</sup> As a result, in the context of ancillary joint ventures, the proposed framework would focus on one primary issue—whether the exempt organization’s distributive share from the joint venture is subject to the UBIT.<sup>296</sup>

In addition, control of the joint venture entity should be irrelevant as to the exempt organization’s tax-exempt status; instead, it may only be relevant in

<sup>289</sup> *Id.*

<sup>290</sup> See *supra* note 40 and accompanying text.

<sup>291</sup> Colombo, *UBIT Framework*, *supra* note 282, at 189. In fact, Professor Colombo states that “under the framework, . . . control is not, and should not be, elevated to the per se rule that Rev. Rul. 98-15 appears to make it. The issue is not control per se; rather the issue is simply whether the venture meets the general criteria of being a charitable activity. Control might also be relevant to analyzing whether a non-charitable activity is ‘related’ or ‘unrelated’ for UBIT purposes . . .” *Id.* at 191. See also Colombo, *Death of Health Care*, *supra* note 282 (“[U]nder the four-alternative analysis for classifying the effects of joint ventures . . . , control should be an issue with regard to *tax-exempt status* only in a whole hospital joint venture.”).

<sup>292</sup> Colombo, *UBIT Framework*, *supra* note 282, at 189-90.

<sup>293</sup> *Id.* at 190.

<sup>294</sup> *Id.*

<sup>295</sup> *Id.*

<sup>296</sup> *Id.*

determining whether the joint venture activity is subject to the UBIT.<sup>297</sup> However, Professor Colombo's proposed framework leaves unresolved the issue of when a venture is truly "ancillary" or insubstantial in comparison to the organization's charitable or exempt activities. Is this an issue that is resolved by the basic tenets of, and case law interpreting, the UBIT? Or, if the IRS does adopt a pure UBIT analysis with respect to ancillary joint ventures, should there be a bright-line rule or defined limitation as to when a joint venture or the aggregate of all the organization's ancillary joint ventures crosses the line from ancillary or insubstantial to substantial? As presented below, a practitioner in the exempt organizations area proposes such a bright-line rule with an aggregation limitation.<sup>298</sup>

Professor Colombo's proposed UBIT analytical framework was implicitly adopted by the ABA Health Section in its proposed revenue ruling regarding ancillary joint ventures submitted to the IRS in 2002.<sup>299</sup> Clearly, the IRS has not adopted Professor Colombo's UBIT-based analysis in addressing whole entity joint ventures because Revenue Ruling 98-15 is "still on the books" and no subsequent revenue ruling has modified it in any way.<sup>300</sup> In Revenue Ruling 2004-51, the IRS appears to adopt in part Professor Colombo's analytical framework with respect to ancillary joint ventures. However, it is not clear that the IRS has or will fully adopt a pure UBIT-based analysis with respect to ancillary joint ventures because, as previously discussed, the revenue ruling does not address certain situations, such as when: (i) the exempt participant in an ancillary joint venture possesses less than fifty percent control on the governing board; (ii) the exempt participant does not have exclusive control over the venture's activities; or (iii) the venture's activities are unrelated to the organization's exempt purposes.<sup>301</sup>

In addition to the IRS's dubious position, this UBIT-based framework is not without criticism. In response to the ABA Health Section's proposed revenue ruling, a practitioner submitted a letter to the director of the IRS's Exempt Organization division raising concerns regarding private benefit.<sup>302</sup> The concerns raised were specific to Situation 2 of the proposed revenue ruling, where the joint venture agreement did not require compliance with the community benefit standard or impose a charity care policy, and the board-adopted business plan emphasized profitability of the venture's operations.<sup>303</sup> In the letter, the author disagreed with the ABA Health Section's statement in the proposed revenue ruling that "the private benefit test does not apply in determining whether an activity is subject to the unrelated business income tax."<sup>304</sup> The author was concerned that the ABA's statement was "tantamount to saying that

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<sup>297</sup> Colombo, *Death of Health Care*, *supra* note 282, at 525. Specifically, the exempt organization's control of the joint venture entity may be relevant in analyzing whether a business activity is "related" or "unrelated" for UBIT purposes.

<sup>298</sup> See *infra* notes 328-36 and accompanying text.

<sup>299</sup> See *supra* notes 238-50 and accompanying text.

<sup>300</sup> See *supra* note 281 and accompanying text.

<sup>301</sup> See *supra* notes 278-81 and accompanying text.

<sup>302</sup> Sarah C. Harlan, *Harlan Letter to IRS on Ancillary Joint Venture Proposal*, 2002 TAX NOTES TODAY, Oct. 10, 2002, at 197-14.

<sup>303</sup> See *supra* notes 242-48 and accompanying text.

<sup>304</sup> Harlan, *supra* note 302; see also *supra* note 245 and accompanying text.

UBI [unrelated business income] and private benefit are mutually exclusive, or that the existence of UBI renders irrelevant the simultaneous existence of private benefit.”<sup>305</sup>

In contrast, the author believed that under the facts of Situation 2 the issue of whether private benefit was conferred on the for-profit participants is dependent on whether the venture’s activity is related or unrelated to the exempt participant’s (i.e., the hospital’s) tax-exempt purposes.<sup>306</sup> Under the facts of Situation 2, a portion of the hospital’s exempt assets, albeit insubstantial, were exempt from tax when earned or received as donations and are now being used to “assist physicians to avoid treating Medicare, Medicaid and charity patients,” which the author contends is directly opposite of the hospital’s exempt mission.<sup>307</sup> Even if the hospital only contributed an insubstantial amount of its exempt assets, a joint venture structured under the facts of Situation 2 could confer “extravagant private benefit, well in excess of any community benefit” generated by the venture.<sup>308</sup> The author noted that an insubstantial portion, or one percent of \$1 billion in hospital revenues, is \$10 million, thereby conferring “substantial, lucrative private benefit.”<sup>309</sup>

However, the criticism of the UBIT-based analysis of ancillary joint ventures on private benefit grounds can easily be addressed by looking to the operational test of Section 501(c)(3), which permits exempt organizations to engage freely in unrelated business activity, provided it is only to an insubstantial degree.<sup>310</sup> In addition, the very purpose of enacting the UBIT was to eliminate unfair competition by taxing, on the same basis as for-profit entities, the income from an exempt organization’s unrelated business activities.<sup>311</sup> As Professor Colombo has argued, if unrelated business activity were not allowed due to the existence of private benefit, there would be no need for the UBIT as any unrelated activity would automatically cause revocation of an organization’s exemption.<sup>312</sup> As to an insubstantial, unrelated activity conferring private benefit on for-profit participants, the IRS does require that any private benefit arising from a business activity, even if insubstantial in relation to the organization’s exempt activities, must be “incidental in both a qualitative and quantitative sense.”<sup>313</sup> Accordingly, the IRS has held an insubstantial unrelated activity will not fail the private benefit test provided the activity is con-

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<sup>305</sup> *Id.*

<sup>306</sup> *Id.*

<sup>307</sup> Sarah C. Harlan, *Harlan Replies to Letter Defending Joint Venture Proposal Against Her Criticism*, 2002 TAX NOTES TODAY, Dec. 16, 2002, at 241-61.

<sup>308</sup> Harlan, *supra* note 302.

<sup>309</sup> *Id.*

<sup>310</sup> See Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990) which states the rule that an exempt organization may engage in activities that do not further its exempt purposes provided it is only to an insubstantial extent. See also Frederick J. Gerhart, *Gerhart Responds to Criticism of Proposed Rev. Rul. on Joint Ventures*, 2002 TAX NOTES TODAY, Nov. 27, 2002, at 238.

<sup>311</sup> HOPKINS, *supra* note 50, § 26.1; see also Treas. Reg. § 1.513-(b) (as amended in 1983).

<sup>312</sup> See Colombo, *UBIT Framework*, *supra* note 282, at 191.

<sup>313</sup> Gerhart, *supra* note 310. See I.R.S. Gen. Couns. Mem. 39,862 (Dec. 2, 1991), available at 1991 IRS GCM LEXIS 39 (advising that a sale of the hospital’s “revenue stream” via a joint venture arrangement constituted a *per se* violation of the private inurement prohibition and a violation of the private benefit doctrine).

ducted on a reasonable and arm's-length basis, as present in the facts of Situation 2 of the proposed revenue ruling.<sup>314</sup>

With respect to the issue of private benefit, Professor Colombo argues that the IRS has greatly expanded the private benefit test well beyond its intended meaning and use.<sup>315</sup> Beginning in the 1970s, primarily in the tax-exempt health care area, the IRS began its expansive interpretation of the private benefit doctrine. Under traditional common law interpretations, as previously discussed, the private benefit doctrine focuses on whether the individuals benefited by the organization's activities constitute a broad cross-section of the community (commonly referred to as the "charitable class") rather than a specific or select group of private individuals.<sup>316</sup> Beginning with the Tax Court's decision in *American Campaign Academy v. Commissioner*,<sup>317</sup> the focus of the private benefit doctrine expanded beyond the charitable class benefiting from the exempt organization's activities to private individuals or interests served "as a result of serving the charitable class."<sup>318</sup> The Tax Court adopted a unique analysis with respect to private benefit, essentially bifurcating the doctrine in two concepts—"primary" and "secondary" private benefit.<sup>319</sup> Although the "primary" benefit of the school in *American Campaign Academy* was the education of its students, which constituted an adequate charitable class because the school did not limit its admissions to any particular individuals, the Tax Court nevertheless found that substantial "secondary" private benefit accrued to the Republican Party because a majority of the school's students were employed by the Party upon graduation. Based on this secondary private benefit, the Tax Court concluded that the school was not operated "exclusively for charitable purposes."<sup>320</sup>

This expanded view and application of the private benefit doctrine has become the bedrock of IRS analysis regarding joint venture arrangements involving exempt organizations, culminating in the IRS's promulgation of Revenue Ruling 98-15.<sup>321</sup> While the private benefit doctrine has considerably more application to a whole entity joint venture because all of the exempt organization's assets and its activities have been contributed to the joint venture, the application of the doctrine to ancillary joint ventures is less clear. Professor Colombo persuasively argues that the application of the private benefit doctrine to an ancillary joint venture, which represents only a portion of an exempt organization's assets and activities, only confuses the real issues at stake—the potential application of the UBIT and whether there is private inure-

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<sup>314</sup> *Id.*, citing Gen. Couns. Mem. 37,789 (Dec. 18, 1978), available at 1978 IRS GCM LEXIS 423 (private benefit only incidental where a tax-exempt hospital loaned money and rented land to staff physicians but received a market rate of interest the loan and fair rental value in return).

<sup>315</sup> See *supra* note 282.

<sup>316</sup> See *supra* notes 68-71 and accompanying text.

<sup>317</sup> *American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989).

<sup>318</sup> Colombo, *UBIT Framework*, *supra* note 282, at 193.

<sup>319</sup> *Id.* See also HOPKINS, *supra* note 50, § 19.10(a), at 523.

<sup>320</sup> Colombo, *UBIT Framework*, *supra* note 282, at 193; *American Campaign Academy*, 92 T.C. at 1073-1079.

<sup>321</sup> Colombo, *UBIT Framework*, *supra* note 282, at 193.

ment.<sup>322</sup> Because the very purpose of a joint venture is to benefit *both* the exempt and for-profit participants, it is only a natural consequence that certain private, for-profit interests will also be served.<sup>323</sup> Furthermore, the language of the operational test of Section 501(c)(3) and the UBIT itself contemplate just this sort of business activity by an exempt organization, provided the level of such unrelated business activity does not rise to the level that the organization is no longer *primarily* operating for exempt purposes.<sup>324</sup>

## 2. Critique of the UBIT Analytical Framework

While the persuasiveness and viability of Professor Colombo's UBIT analytical framework are undeniable, the framework's very weakness is its reliance on the UBIT, which has its own inconsistencies and uncertainties.<sup>325</sup> Specifically, as mentioned above, the weakness lies in categories (3) and (4) of the framework, which still leaves unresolved the fundamental UBIT issue that arises in the context of any unrelated business activity—at what level or to what extent will an organization's unrelated business activities, including an ancillary joint venture (which generally involves only a portion of an exempt organization's assets), be considered "substantial," thereby jeopardizing its tax-exempt status?

In other words, when will a joint venture, which constitutes an unrelated business activity, be considered truly "ancillary" or insubstantial in comparison to the organization's charitable or exempt activities for purposes of applying the UBIT rules? As discussed in the overview of the UBIT contained in Part II of this Article, the basic tenets of, and case law interpreting, the UBIT do not clearly resolve this issue.<sup>326</sup> No standard has been clearly articulated and consistently applied that resolves when an organization engages in a more than "insubstantial" (i.e., too "substantial") amount of unrelated business activity and, as a result, threatens the denial or revocation of its tax-exempt status.<sup>327</sup>

Accordingly, the UBIT analytical framework can provide two extremely divergent end results for an exempt organization that participates in an ancillary

<sup>322</sup> *Id.* at 193-94.

<sup>323</sup> *Id.* at 194.

<sup>324</sup> See *supra* notes 78-79 and accompanying text.

<sup>325</sup> Harris, *supra* note 8, at 29 ("the unrelated business income tax is an imperfect and 'inherently vague' tax").

<sup>326</sup> See notes 92-101 and accompanying text. In fact, Professor Colombo acknowledges the issue of "how much commercial activity is 'too much,'" but states that "[t]he best that can be said is that there are no fixed percentage guidelines for determining the answer to this question and that other facts and circumstances (such as the amount of employee time spent on charitable [exempt] pursuits) may be equally important." Colombo, *Death of Health Care*, *supra* note 282, at 536 n.91.

<sup>327</sup> Harris, *supra* note 8, at 30. In the article, Professor Stephen Schwarz, in commenting on commercial activities of exempt organizations, identified "two competing camps on the 'impact of unrelated business activities on an organization's exempt status.'" One camp assumes that an exempt organization can engage in some unrelated business but once the unrelated business *exceeds a vaguely defined benchmark*, exempt status can be revoked. . . . The second camp suggests that there is no per se limit on the amount of unrelated business an organization can engage in, if the organization carries on a charitable program commensurate in scope within its financial resources.

*Id.* (emphasis added).

joint venture, as set forth in categories (3) and (4), respectively—payment of the UBIT on income from the joint venture or the loss of its tax exemption. While a pure UBIT-based approach may satisfactorily address ancillary joint ventures that are truly “ancillary” or represent only a small or insignificant portion of their overall activities, the approach does leave an exempt organization that participates in an ancillary joint venture that comprises a greater portion of its total activities, yet does not constitute a whole entity joint venture (e.g., forty percent of the organization’s activities are attributable to ancillary joint venture(s)), open to revocation of its exemption under traditional UBIT standards. Therefore, unless the IRS issues additional guidance providing a more clear and consistent standard as to what constitutes an “insubstantial” and “substantial” level of unrelated business activity under the UBIT rules, this pure UBIT-based approach will leave exempt organizations and tax practitioners with the same uncertain result as the current IRS control standard.

## *B. Quantitative Test Proposal*

### *1. Overview of the Quantitative Test Proposal*

Recognizing that ancillary, as opposed to whole entity, joint ventures are the type of ventures most often used by exempt organizations, Michael I. Sanders, a noted practitioner, author, and professor in the area of exempt organizations law, has suggested that the IRS should apply “quantitative standards and a significantly relaxed set of rules” with respect to the federal income tax treatment of such ventures.<sup>328</sup> Mr. Sanders first calls upon the IRS to provide a clear statement that ancillary joint ventures do not affect the exempt status of the exempt participant “simply because of defects in management control” of the venture, and that Revenue Ruling 98-15 is “not directly applicable to ancillary ventures.”<sup>329</sup> Rather, as advocated by Professor Colombo, the IRS’s analysis should center on the UBIT issue.<sup>330</sup> The control standard, as prominently established in Revenue Ruling 98-15 and discussed at length herein, would be irrelevant in the application of the UBIT rules, especially if the “substantially related” test is satisfied.<sup>331</sup>

Mr. Sanders essentially proposes a “numerical test” to distinguish ancillary joint ventures from the whole entity joint venture addressed in Revenue Ruling 98-15. This test would be based on an exempt organization’s total assets, i.e. assets used both in activities directly related to its exempt purposes and in other activities.<sup>332</sup> The application of a numerical or quantitative test “would provide a satisfactory bright-line standard [or safe harbor], and would preclude any need to examine a percentage of revenue” under the [UBIT] rules and the operational test of Section 501(c)(3).<sup>333</sup> Mr. Sanders proposes that ten

<sup>328</sup> SANDERS, *supra* note 6, Supp. § 4.4A(c), at 55.

<sup>329</sup> *Id.* Sanders also notes that private inurement should be possibly be part of the IRS’s analysis.

<sup>330</sup> *Id.*

<sup>331</sup> *Id.* (Sanders notes that in ancillary joint ventures an exempt organization may possess “effective control” of the venture even though it holds less than a majority ownership interest or voting rights if there is a large number of for-profit participants in the venture).

<sup>332</sup> *Id.*

<sup>333</sup> *Id.* See also Harris, *supra* note 239, at 183-84.

to fifteen percent of an exempt organization's total assets could be used in ancillary joint ventures without a negative impact on its tax-exempt status. Mr. Sanders further provides that an aggregation limitation would be reasonable and appropriate to prevent abuse of such a standard by engaging in a number of ancillary joint ventures that each fit within the safe harbor. When viewed in the aggregate, such individual ancillary transactions may no longer be ancillary.<sup>334</sup>

## 2. Critique of the Quantitative Test Proposal

Clearly, such a bright-line rule combined with an aggregation limitation would provide a more certain standard for exempt organizations and tax practitioners to apply in analyzing the federal income tax consequences of a contemplated joint venture. However, the very inability of the IRS and reviewing courts to adopt and apply a clear and consistent standard differentiating between what constitutes "insubstantial" vs. "substantial" unrelated business activities under the UBIT seems to support the unlikelihood that any bright-line standard or safe harbor will be adopted with respect to ancillary joint ventures.<sup>335</sup> Furthermore, the lack of a consistent application of any one standard under the UBIT rules only underscores the difficulty of attempting to devise a workable bright-line standard for consistent application to ancillary joint ventures. In fact, a review of a sampling of UBIT rulings and cases reveals that a more facts-and-circumstances approach was utilized in reaching a conclusion rather than any bright-line rule or consistent measurement.<sup>336</sup> Notwithstanding the current realities regarding the application of the UBIT rules, the IRS should seriously consider adopting some sort of quantitative standard or safe harbor in applying the UBIT to ancillary joint ventures, or issuing guidance that provides some alternative resolution to the issue, as further discussed below in Part IV.<sup>337</sup>

Regardless of the approach adopted by the IRS, any guidance clarifying the issues discussed above with the respect to the UBIT rules will ensure that such rules are an available and effective resource for the IRS in addressing the issues raised by ancillary joint ventures. Such availability of the UBIT rules, along with the proposed modifications, is the first-prong in the proposal set forth below as an alternative to the current control standard.

## IV. AN ALTERNATIVE TO THE IRS CONTROL STANDARD WITH RESPECT TO ANCILLARY JOINT VENTURES

### A. *The Inadequacy of the Control Standard as to Ancillary Joint Ventures*

As previously discussed, to date the IRS has primarily utilized a control standard in determining the federal income tax consequences of an exempt organization's participation in a joint venture, ancillary or whole hospital, with

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<sup>334</sup> *Id.* at 184.

<sup>335</sup> See *supra* notes 92-101 and accompanying text.

<sup>336</sup> See *supra* notes 92-101 and accompanying text.

<sup>337</sup> See *infra* notes 344-48 and accompanying text.

for-profit participants.<sup>338</sup> With respect to whole hospital or whole entity joint ventures, this Article does not propose that the IRS should abandon the use of a control standard. In such instances, control of the joint venture is arguably more warranted because the joint venture is now the sole activity of the exempt organization. However, in the context of ancillary joint ventures, the IRS's control standard is less appropriate and economically unrealistic because the joint venture is not the exempt organization's primary activity and may only represent an insignificant or relatively small portion of its overall activities whether measured in time, expenditures, or both. Upon review of the evolution of the IRS control standard from its origins in the two-prong test of GCM 39,005,<sup>339</sup> it appears that the IRS has utilized such a standard primarily to prevent two possible negative outcomes from a joint venture arrangement: (i) The exempt organization's participation in the joint venture will not further its exempt purposes, thereby potentially causing the organization to fail to operate "exclusively" for exempt purposes as required under the operational test of Section 501(c)(3);<sup>340</sup> and (ii) the venture confers a benefit on the for-profit participants that may be substantial, thereby resulting in the exempt organization operating more for private than for public benefit (i.e., also violating the operational test of Section 501(c)(3)).

In the context of an ancillary joint venture, the current control standard fails to address the IRS's first concern adequately because the determination of whether an exempt organization's participation in such a venture will cause it to fail the operational test of Section 501(c)(3) depends almost entirely on whether the activities conducted by the joint venture are related or unrelated to the organization's exempt purposes. In making such a determination, the UBIT regime, with its origins in the operational test, provides a more appropriate and viable approach than the control standard. For instance, if the ancillary joint venture's activities at their inception are unrelated to the exempt organization's purposes, control of the venture by the exempt organization will not change the fact that its participation in the venture constitutes an unrelated business activity. Rather, the extent of the organization's participation in the joint venture and the degree of the organization's other unrelated business activities in relation to its overall exempt activities or function is determinative.

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<sup>338</sup> As previously discussed, Rev. Rul. 98-15 relies almost exclusively on the exempt organization's control of the joint venture in determining the federal income tax consequences of the organization's participation in a whole hospital joint venture. See *supra* note 173 and accompanying text. As to ancillary joint ventures, the IRS, until recently, has similarly relied on such a control standard in making its determination. In its most recent ruling on ancillary joint ventures (Rev. Rul. 2004-51), the IRS deviates from such standard and permits the exempt organization and for-profit participant to share control equally, but nevertheless relies on the exempt organization's exclusive control over the activity of the joint venture (which furthers the organization's exempt purposes) in reaching its favorable conclusion. As discussed herein, Rev. Rul. 2004-51 shows some progress on the IRS's part, but still fails to address ancillary joint ventures where the exempt organization lacks equal or greater control over the venture and/or its activities. See *supra* notes 278-81 and accompanying text.

<sup>339</sup> See *supra* notes 121-29 and accompanying text.

<sup>340</sup> See *supra* notes 45-47 and accompanying text for a discussion of the operational test of I.R.C. § 501(c)(3).



As to the IRS's second concern with respect to private benefit, this Article has already discussed in the context of the UBIT-based approach that private benefit to the for-profit participant in an ancillary joint venture is a natural consequence of the venture and, as with unrelated business activity under the UBIT, an insubstantial amount can occur without jeopardizing an organization's exemption.<sup>341</sup> Therefore, it seems that the IRS should place less emphasis on whether private benefit is being conferred in the context of an ancillary joint venture and more focus on the amount of the benefit, particularly in the form of the venture's earnings, being conferred to the for-profit participants and whether the private inurement prohibition is implicated.<sup>342</sup> As discussed below, the IRS acknowledges in its own internal guidelines that joint ventures are ripe for private inurement risk.<sup>343</sup> To address this risk, the IRS needs to employ an already available resource more effectively—namely, the intermediate sanctions rules, which are discussed in greater detail below.

### B. *The Alternative Proposal*

In offering an alternative to the current IRS utilization of a control standard, this Article makes a simple, yet significant, observation—the IRS need only use resources already in its possession, with some modification, to more adequately and effectively determine the federal income tax consequences of an exempt organization's participation in an ancillary joint venture. Accordingly, this Article proffers an alternative, two-pronged approach. First, this Article proposes that the IRS utilize the UBIT, as discussed in Professor Colombo's and Mr. Sander's proposals, to determine whether an exempt organization furthers its own exempt purposes through its participation in the ancillary joint venture. However, as stated above, in order for the UBIT to be truly effective in such instances, the IRS will need to provide additional guidance in the form of clearer and more consistently-applied standards as to what amount of time, expenditures, or both, will constitute more than an insubstantial versus a substantial amount of unrelated business activity.

One alternative, as proposed by Mr. Sanders, is for the IRS to issue and adopt a defined, quantitative standard. For instance, the IRS could borrow the meaning of "substantially all" used in the corporate reorganization context (i.e., at least ninety percent of the fair market value of the net assets and at least

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<sup>341</sup> See *supra* notes 68-70, 315-24 and accompanying text. See also Paul Streckfus, *Ancillary Joint Ventures May Involve Exemption Risk*, 106 TAX NOTES, Jan. 31, 2005, at 603 (Author asserts that, in the absence of private inurement, the "majority view" is that an exempt organization's exemption "is safe in any situation in which the activities conducted by a joint venture are an insubstantial part of the EO's [exempt organization's] activities, even when those activities result in substantial or excessive private benefit to the for-profit partner.").

<sup>342</sup> For the proposition that the concepts of private benefit and private inurement overlap and the intermediate sanctions rules can impact both concepts, see *supra* note 75 and accompanying text.

<sup>343</sup> See *infra* note 351 and accompanying text. See also SANDERS, *supra* note 6, § 1.16, at 222 ("The first concern [with having an exempt organization as a joint venture partner] is whether any of the financial or nonfinancial arrangements contemplated by the joint venture results in the inurement of any portion of the exemption organization's earnings to an officer, director, founder . . . of the exempt organization.").

seventy percent of the fair market value of the gross assets held by the target corporation immediately prior to the transfer)<sup>344</sup> to determine what is an “insubstantial” amount for UBIT purposes (i.e., the remainder). In other words, the IRS should adopt a standard setting forth the amount of assets an exempt organization can contribute to an ancillary joint venture without jeopardizing its exemption. In the reorganization context, the IRS’s primary concern is that a sufficient amount of the target corporation’s assets is being transferred to the acquiring corporation in order for the transaction to be tax-free in whole or in part. Although the facts are converse, the IRS’s concern is similar in the ancillary joint venture context—namely, that the exempt organization not transfer too much of its assets (i.e., retain a substantial amount of its assets) in order to continue to meet the operational test under Section 501(c)(3). Furthermore, the rulings and case law interpreting the “substantially all” standard in the reorganization context could be similarly useful in the application of the UBIT rules to ancillary joint ventures.<sup>345</sup>

As an alternative to devising a bright-line, quantitative standard that can be consistently applied in most situations, the IRS might consider adopting a variation of the intermediate sanctions regime currently applied in the context of private inurement, as described in detail below, to address situations where an exempt organization’s unrelated business activities are more than an insubstantial amount of its total exempt activities, yet not at a level that the IRS feels is injurious to the organization’s tax-exempt status.<sup>346</sup> The use of such a UBIT intermediate sanctions regime would permit the IRS to retain its current facts-and-circumstances approach in determining whether the amount of an exempt organization’s unrelated business activity is substantial. If the amount of an exempt organization’s unrelated business activity is *more than* insubstantial based on the facts and circumstances (i.e., “excess” unrelated business activity), the IRS would have the option to impose some sort of additional penalty, such as a higher rate of tax than otherwise imposed by the UBIT rules or an addition to tax, either of which is less severe than the revocation of an organization’s tax-exempt status. In addition to assessing a penalty in a situation involving excess unrelated business activity, the IRS could require “correction” (as mandated in the private inurement context)<sup>347</sup> by the exempt organization whereby the organization either divests itself of all or a portion of its interests in an unrelated business activity or activities to the extent of such excess amount, or

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<sup>344</sup> I.R.C. § 368(a)(1)(C) (2004) (failing to define “substantially all”). For purposes of obtaining a private letter ruling on a proposed reorganization, the IRS’s advance ruling guidelines provide that the “substantially all” requirement will be met if the proposed transfer of assets satisfies such 90 percent and 70 percent tests. See Rev. Proc. 77-37, 1977-2 C.B. 568 and Rev. Proc. 86-42, 1986-2 C.B. 722.

<sup>345</sup> I.R.C. § 368(a)(1)(C) (2004); see also, e.g., *Comm’r v. First Nat’l Bank of Altoona*, 104 F.2d 865 (3d Cir. 1939), cert. denied, 309 U.S. 691 (1940); *Pillar Rock Packing Co. v. Comm’r*, 90 F.2d 949 (9th Cir. 1937); *National Bank of Commerce of Norfolk v. U.S.*, 158 F. Supp. 887 (E.D. Va. 1958); Rev. Rul. 78-47, 1978-1 C.B. 113; Rev. Rul. 57-518, 1957-2 C.B. 253.

<sup>346</sup> See *infra* notes 355-81 and accompanying text. Obviously, an adoption of such a regime would require amendments to statutory provisions implementing the UBIT, which would require Congressional involvement.

<sup>347</sup> See *infra* note 378 and accompanying text.

modify one or more of such activities to meet the "substantially related" standard under the UBIT rules (i.e., no longer qualify as an unrelated business activity).<sup>348</sup> As previously stated, regardless of the approach adopted by the IRS, any guidance clarifying the issues with respect to the UBIT rules will ensure that such rules are an available and effective resource for the IRS in addressing the issues raised by ancillary joint ventures.

The use of a UBIT-based approach addresses only one-half of the two underlying reasons for the IRS's use of a control standard. Accordingly, this Article also proposes that the IRS should more effectively utilize the intermediate sanctions rules, including the release of additional guidance, to address the potential of too much financial benefit being conferred to the for-profit participants pursuant to the joint venture arrangement. Because the very purpose of such intermediate sanctions rules under Section 4958<sup>349</sup> was to give the IRS options between the two widely-divergent ends of either maintaining or revoking tax-exempt status in instances of impermissible private inurement (i.e., too much financial benefit), these rules provide the IRS with an effective and more appropriate resource to address any such issues raised in an ancillary joint venture arrangement.

Although Section 4958 and the regulations thereunder do not directly address joint ventures between exempt organizations and for-profit entities, the potential impact of intermediate sanctions on such ventures should not be underestimated or overlooked, because joint ventures by their very nature raise the real possibility of private inurement.<sup>350</sup> This possibility is not completely unknown to the IRS, which acknowledges in its Hospital Audit Guidelines that "[j]oint ventures between taxable and exempt parties must be carefully examined for [private] inurement."<sup>351</sup> Neither the IRS nor scholars and commentators in the exempt organizations area have discussed the availability and application of the intermediate sanctions rules in determining the proper federal income tax treatment of such ventures in any great detail, although such availability and application are often mentioned in the context of joint venture arrangements.<sup>352</sup> This lack of discussion may be due, in part, to the difficulty in determining whether such rules can apply in the joint venture context—spe-

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<sup>348</sup> See *supra* notes 84-87 and accompanying text for a discussion of unrelated and related business activities.

<sup>349</sup> See *infra* notes 358-81 and accompanying text.

<sup>350</sup> See SANDERS, *supra* note 6, Supp. § 5.4, at 70, and Supp. § 11.3, at 151-67 ("Compliance with the guidelines of the intermediate sanctions provisions is particularly important in regard to joint ventures between for-profit and nonprofit organizations. . . . [W]henver nonprofits engage in a transaction with one or more for-profit entities, the potential for impermissible benefit and inurement issues is inherent.").

<sup>351</sup> IRS EXEMPT ORGANIZATIONS EXAMINATION GUIDELINES HANDBOOK (IRM 7(10)(69) § 333, § 333.4(2) (hereinafter, HOSPITAL AUDIT GUIDELINES), reproduced by IRS for broader dissemination in Announcement 92-83, 1992-22 I.R.B. 59.

<sup>352</sup> To date, in administrative rulings, IRS continuing education material and overall legal publications, the intermediate sanctions seem to be discussed primarily in the health care field and most often in the context of executive or physician compensation, or physician recruitment. Cf. SANDERS, *supra* note 6, § 11.3(c), where Sanders discusses that there are numerous reasons as to the importance of the intermediate sanctions in nonprofit participation in joint ventures. First, the IRS typically scrutinizes such ventures for the existence of excess benefit and private inurement. Second, several forms of compensation typical in the

cifically, whether the requisite “disqualified person” and “excess benefit,” each of which is defined and discussed below, exist in a particular joint venture arrangement.<sup>353</sup>

In analyzing the viability of the alternative proposal, this Article has already discussed the strengths and weaknesses of the UBIT prong of the proposal, including the need for additional IRS guidance therein. Accordingly, this Article will next provide a necessary overview of the enactment of Section 4958 and a primer on the regulations promulgated thereunder. This Article will then discuss the application of the intermediate sanctions rules in the ancillary joint venture context, focusing primarily on the “disqualified person” and “excess benefit transactions” components of the rules. Although this Article does not attempt to address and resolve the myriad of issues that may arise in applying intermediate sanctions to ancillary joint ventures, it nevertheless attempts to establish the viability of using such sanctions to more properly determine the federal income tax treatment of ancillary joint ventures and to address the IRS concerns that led to its use of the control standard. Finally, this Article will address the potential criticisms of the second prong of this alternative proposal.

### C. *A Primer On Intermediate Sanctions*<sup>354</sup>

#### 1. *Historical Overview*

As previously discussed, Section 501(c)(3) contains an absolute prohibition on the inurement of any of an exempt organization’s net earnings to private individuals, commonly referred to as “insiders.”<sup>355</sup> The term “insiders” is used to describe individuals that have a relationship with the exempt organization in which they can exert influence and affect decision making. Prior to 1996, the sole enforcement mechanism available to the IRS with respect to organizations exempt under Section 501(c)(3), other than private foundations (i.e., organizations classified and referred to as “public charities”<sup>356</sup>), that participated in transactions with private individuals or for-profit entities that resulted in impermissible private inurement was revocation of the organization’s tax-exempt sta-

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health care sector invite IRS scrutiny (e.g., incentive compensation, revenue-sharing, and physician recruitment).

<sup>353</sup> *Id.* (Sanders does note that the recipient of any excess benefit must be an “insider” in order for any sanctions to be imposed).

<sup>354</sup> See Lisa D. McLaughlin & Nicholas A. Mirkay, *Traps for the Unwary: Exempt Organizations’ Compliance With The Intermediate Sanctions Rules and Lobbying and Political Campaigning Prohibitions*, 49 ST. LOUIS B.J. 18 (Spring 2003). Portions of the discussion on intermediate sanctions are reprinted with the permission of the co-author, the Bar Association of Metropolitan St. Louis and the St. Louis Bar Journal.

<sup>355</sup> See *supra* notes 58-67 and accompanying text. The private inurement prohibition is similarly imposed on organizations exempt under I.R.C. § 501(c)(4) (2004).

<sup>356</sup> An organization that meets the requirements of I.R.C. § 501(c)(3) (2004) is either classified as a (i) “public charity” under one of the four provisions of I.R.C. § 509(a) (2004) (such provisions based primarily on an organization’s sources of financial support), or (ii) a “private foundation.” An organization is considered a private foundation if it does *not* meet the requirements of any of such I.R.C. § 509(a) provisions. A private foundation typically receives contributions from only a few individuals or entities, whereas a public charity typically receives its income from a broader segment of the general public in the form of gifts, contributions, or receipts from performance of services. A private foundation is subject to its own set of excise tax rules governing “self-dealing” transactions (I.R.C. § 4941 (2004)) or transactions that fail to accomplish a charitable purpose (I.R.C. § 4945 (2004)).

tus. This revocation remedy was often viewed as “unduly harsh,” considering that the amount of private inurement may be relatively small in proportion to the exempt organization’s total assets and that revocation of exempt status punishes the exempt organization and its charitable beneficiaries rather than the insider who benefits from the inurement.<sup>357</sup>

To address these concerns, Congress enacted Section 4958 as part of the Taxpayer Bill of Rights 2 in 1996,<sup>358</sup> empowering the IRS to impose penalty excise taxes or “intermediate sanctions” on exempt organization insiders (now referred to as “disqualified persons,” as discussed below) who benefit from “excess benefit transactions” with exempt organizations. These sanctions are less severe than revocation of an organization’s exempt status, thus the term “intermediate sanctions.” Such sanctions are intended to be the penalty of choice in transactions where the excess benefit conferred by an exempt organization “does not rise to such a level as to call into question whether, on the whole, the organization functions as an exempt charitable or social welfare organization.”<sup>359</sup> The Treasury Department issued both proposed and temporary regulations interpreting and implementing Section 4958, with final regulations being issued and effective on January 22, 2002 (hereinafter, the ‘Regulations’).<sup>360</sup>

## 2. Statutory and Regulatory Overview

The key to understanding the imposition of intermediate sanctions under Section 4958 is to be familiar with the terminology utilized, in the statute and the Regulations.

An “applicable tax-exempt organization” (“ATEO”) is an organization described in either Section 501(c)(3) or (c)(4) and exempt from tax at any time during a five-year period ending on the date of an excess benefit transaction (referred to as the “lookback period”).<sup>361</sup> As explained above, only organizations exempt under Section 501(c)(3) and classified as public charities under Section 509(a) are included in this definition.<sup>362</sup>

A “disqualified person” is any person who, during the lookback period, was “in a position to exercise substantial influence over the affairs” of an ATEO.<sup>363</sup> Certain family members and thirty-five-percent-owned entities of a

<sup>357</sup> See SANDERS, *supra* note 6, Supp. § 5.4, at 96; see also HOPKINS, *supra* note 50, § 19.11

<sup>358</sup> Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1311(a), 110 Stat. 1452, 1475-77 (1996) (added I.R.C. § 4958, effective for excess benefit transactions occurring on or after Sept. 14, 1995).

<sup>359</sup> HOPKINS, *supra* note 50, § 19.11(i), at 540; see also H. REP. NO. 104-506, at 59 n.15 (1996) which states:

In general, the intermediate sanctions are the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.

<sup>360</sup> See Treas. Reg. § 53.4958-1 et al. (2002).

<sup>361</sup> I.R.C. § 4958(e) (2004).

<sup>362</sup> *Id.*

<sup>363</sup> *Id.* at § 4958(f)(1)(A) (2004).

disqualified person are statutorily defined as being disqualified persons.<sup>364</sup> Under the Regulations, certain persons are deemed to have substantial influence including voting members of the governing body of the organization (board of directors or trustees) and certain officers or positions with similar authority (presidents, chief executive officers, chief operating officers, treasurers).<sup>365</sup> Certain facts and circumstances can also lead to the determination that substantial influence is present, which will be discussed in greater detail below.<sup>366</sup>

An "organization manager" is any officer, director or trustee of an ATEO, including an individual having power or responsibilities similar to one of those persons.<sup>367</sup> Generally, an independent contractor (e.g., an attorney, accountant, or investment advisor) or a person who can recommend but not implement action without another's approval are not deemed to be organization managers.<sup>368</sup>

Excise taxes under Section 4958 can only be imposed in instances where an "excess benefit transaction" (an "EBT") occurs.<sup>369</sup> An EBT is defined as a transaction in which an economic benefit is provided by an ATEO directly or indirectly to any disqualified person and the value of the economic benefit provided by such ATEO exceeds the value of the consideration,<sup>370</sup> including the performance of services, received in return (i.e., the "excess benefit").<sup>371</sup> In determining whether an EBT has occurred, all consideration and benefits exchanged directly between a disqualified person and the ATEO, or indirectly through a controlled entity or intermediary of the ATEO, must be taken into account.<sup>372</sup> Generally, most components of compensation, whether or not included in the recipient's gross income, are considered in determining reason-

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<sup>364</sup> *Id.* at § 4958(f)(1) (2004). I.R.C. § 4958(f)(3) defines a "35% controlled entity" as including: (i) a corporation in which a person described in I.R.C. § 4958(f)(1)(A) or (B) (a person in a position to exercise substantial influence over the applicable tax-exempt organization ("ATEO") during the five-year period ending on the date of the transaction in question, and certain members of such a person's family) "own[s] more than 35% of the total combined voting power, (ii) a partnership in which such persons own more than 35% of the profits interest, and (iii) a trust or estate in which such persons own more than 35% of the beneficial interest."

<sup>365</sup> *See* Treas. Reg. § 53.4958-3(c) (2002). The Regulations also specify certain persons not considered to have substantial influence over the exempt organization's affairs including another organization exempt under I.R.C. § 501(c)(3) (2004), and non-highly-compensated employees as defined under I.R.C. § 414(q)(1)(B)(i) (2004), provided the employee does not meet any of the I.R.C. § 4958(f)(1) definitions nor constitutes a substantial contributor. Treas. Reg. § 53.4958-3(d) (2002).

<sup>366</sup> *See* Treas. Reg. § 53.4958-3(e) (2002) and *infra* notes 386-94 and accompanying text.

<sup>367</sup> I.R.C. § 4958(f)(2) (2004).

<sup>368</sup> *See* Treas. Reg. § 53.4958-1(d)(2) (2002).

<sup>369</sup> I.R.C. § 4958(f)(1)(A) (2004).

<sup>370</sup> In determining the value of economic benefits for purposes of I.R.C. § 4958 (2004), the Regulations provide that the value of the property, including the right to use the property, is the fair market value of such property or right. The value of services is "the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation)." Treas. Reg. § 53.4958-4(b)(1)(i), (ii) (2002).

<sup>371</sup> I.R.C. § 4958(c)(1) (2004).

<sup>372</sup> *See* Treas. Reg. § 53.4958-4(a) (2002).

ableness under Section 4958.<sup>373</sup> EBTs can arise in a variety of situations and transactions with disqualified persons including, but not limited to, compensation, loans, and revenue-sharing arrangements. Section 4958 does provide an exception, commonly referred to as the “initial contract exception,” pursuant to which any non-discretionary, fixed payment received pursuant to an *initial* contract executed by the ATEO and an individual who is not a disqualified person immediately prior to the contract’s execution is *not* considered an EBT.<sup>374</sup>

The Regulations provide a “rebuttable presumption” for compensation arrangements. Under such presumption, compensation is presumed to be reasonable and transfers of property or rights to use property are presumed to be at fair market value provided certain conditions are met, including the gathering of comparable data from other similarly-situated organizations.<sup>375</sup> If the presumption is adequately invoked, the IRS may only rebut the presumption if it possesses “sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the [ATEO’s] authorized body.”<sup>376</sup> This rebuttable presumption is the key component in complying with the intermediate sanctions rules.<sup>377</sup>

The amount of potential excise taxes imposed under Section 4958 can be substantial. Disqualified persons are subject to a first-tier tax of twenty-five percent of the amount of the Excess Benefit. If the EBT is not “corrected” within a specified period of time,<sup>378</sup> a second-tier tax of 200 percent can also be imposed on the disqualified person. If a tax is imposed on the disqualified person, a separate excise tax of ten percent of the Excess Benefit can also be imposed on each organization manager who “knowingly”<sup>379</sup> participated in or

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<sup>373</sup> See Treas. Reg. § 53.4958-4(b)(1)(ii)(B)(3) (2002) for other compensatory benefits included in such a determination.

<sup>374</sup> See Treas. Reg. § 53.4958-4(a)(3) (2002) for defined terms and additional discussion.

<sup>375</sup> Treas. Reg. § 53.4958-6(c) (2002). The requirements for meeting the presumption are: (i) the arrangement or transfer must be approved in advance by the ATEO’s governing board composed of disinterested directors; (ii) the governing board must obtain “comparable data” in making its determination (e.g., compensation paid by similarly-situated organizations, both taxable and tax-exempt, for functionally comparable positions, or current independent appraisals establishing a property’s value); (iii) the governing board documents its determination; and (iv) the payment is fixed or determined according to a specified fixed formula that is subject to a stated cap. Treas. Reg. § 53.4958-6(a), (d) (2002).

<sup>376</sup> Treas. Reg. § 53.4958-6(b) (2002).

<sup>377</sup> See Steven T. Miller, *Rebuttable Presumption Procedure is Key to Easy Intermediate Sanctions Compliance*, <http://www.irs.gov/pub/irs-tege/m4958a2.pdf> (last visited Aug. 25, 2005) (discussing the presumption and provides a checklist for organizations-use in complying with the regulations).

<sup>378</sup> In order to correct an EBT, the disqualified person must: (i) undo the Excess Benefit to the extent possible; and (ii) take any additional measures necessary to place the ATEO in a financial position no worse than if the disqualified person had been dealing with the ATEO under the “highest fiduciary standards.” Treas. Reg. § 53.4958-7(a) (2002). The disqualified person may also return the property to the ATEO to correct the EBT if such transaction involved specific property and the ATEO consents. Treas. Reg. § 53.4958-7(a), (b)(4). (2002).

<sup>379</sup> “Knowing” means that a person has actual knowledge, not reason to know, of facts sufficient to determine that the transactions in an EBT and negligently fails to make a reasonable attempt to ascertain that it is or in fact knows that it is one. Reliance on professional advice can negate this knowledge element. Treas. Reg. § 53.4958-1(d)(4) (2002).

approved such EBT, unless such participation was not “willful”<sup>380</sup> and was due to “reasonable cause.”<sup>381</sup> No tax is imposed on the ATEO itself.

*D. Applying the Intermediate Sanctions Rules to Ancillary Joint Ventures*

*1. The Disqualified Person in an Ancillary Joint Venture*

In order for the IRS to use these intermediate sanctions effectively in a joint venture setting, the venture must necessarily involve a disqualified person and confer excess benefit to such a person. As discussed above, the statutory definition of a disqualified person includes any person who, during the look-back period, was “in a position to exercise substantial influence over the affairs” of an exempt organization, and certain family members and thirty-five-percent-owned entities of such a person.<sup>382</sup> The Regulations define persons that have “substantial influence” to include voting board members of the exempt organization as well as certain officers or positions with similar authority (e.g., presidents, chief executive officers, chief operating officers, treasurers).<sup>383</sup> However, a person having the title of a director, trustee, or officer is not automatically considered a disqualified person, but rather must have the requisite voting ability or authority to implement decisions of the board and manage the organization.<sup>384</sup> Accordingly, if an exempt organization enters into a joint venture with one of its board members or officers, certain family members of such board members or officers, or entities in which such members or officers own at least a thirty-five percent stake, the joint venture could subject certain of its parties to possible Section 4958 excise tax if excess benefit is found to exist. However, if the joint venture does not include as a party one of such persons or entities, the determination of whether any party to the joint venture constitutes a disqualified person, and, thus, whether intermediate sanctions may be applied, will necessarily involve a facts-and-circumstances analysis.<sup>385</sup>

Under the Regulations, facts and circumstances that tend to establish that a person or entity has substantial influence include, but are not limited to: (i) the person founded the exempt organization; (ii) the person is a substantial contributor to the organization;<sup>386</sup> (iii) the person’s compensation is based on revenues derived from activities of the exempt organization, including a particular department or function of the organization, that the person controls (commonly referred to as “revenue-sharing”); (iv) the person has authority to control or determine a substantial portion of the exempt organization’s capital expenditures, operating budget, or employee compensation; (v) the person has manage-

<sup>380</sup> “Willful” means voluntary, conscious and intentional. However, an organization manager’s participation is not willful if the manager does not know that the transaction constitutes an EBT. Treas. Reg. § 53.4958-1(d)(5) (2002).

<sup>381</sup> “Reasonable cause” exists if the manager has exercised responsibility owed to the organization with ordinary business care and prudence. Treas. Reg. § 53.4958-1(d)(6) (2002).

<sup>382</sup> See *supra* note 364 and accompanying text.

<sup>383</sup> See *supra* note 365 and accompanying text.

<sup>384</sup> See H.R. REP. NO. 104-506, at 58 (1996), *reprinted in* 1996 U.S.S.C.A.N. 1143, 1181; see also Treas. Reg. § 53.4958-3(c) (2002).

<sup>385</sup> See *supra* note 366 and accompanying text.

<sup>386</sup> See I.R.C. § 507(d)(2)(A) (2004)(defining a “substantial contributor”).



rial authority; or (vi) the person owns a controlling interest in an entity that constitutes a disqualified person.<sup>387</sup> For instance, the legislative history states that physicians, who previously were automatically considered “insiders” with respect to the tax-exempt hospital in which they were on staff, will be considered disqualified persons “only if they are in a position to exercise substantial influence over the affairs of the organization.”<sup>388</sup> As applied in the context of joint ventures, the Regulations provide the following example illustrating when a person or entity has “substantial influence” and therefore constitutes a disqualified person:

A [is an] exempt organization. . . that owns and operates one acute care hospital. B, a for-profit corporation, owns and operates a number of hospitals. A and B form C, a limited liability company. In exchange for proportional ownership interests, A contributes its hospital and B contributes other assets to C. [Subsequently, A’s only asset] consist[s] of its membership interest in C [and it continues to operate exclusively for charitable purposes based on the activities it conducts through C.] C enters into a management agreement with M, a management company, to provide day-to-day management services to C. Subject to supervision by C’s board, M is given broad discretion to manage C’s operations and has ultimate responsibility for supervising the management of the hospital. Because M [(i)] has ultimate responsibility for supervising the management of the hospital operated by C, . . . [(ii)] A’s ownership interest in C constitutes its primary asset, and [(iii)] C’s activities form the basis for A’s continued exemption under Section 501(c)(3), M is in a position to *exercise substantial influence* over A’s affairs. Therefore, M is a disqualified person with respect to A.<sup>389</sup>

The above example involving a whole hospital joint venture is similar to one contained in the section of the proposed regulations on Section 4958 issued in early August 1998 (the “Proposed Regulations”) devoted to revenue-sharing arrangements that constitute excess benefit transactions.<sup>390</sup> As discussed further below, revenue-sharing arrangements are particularly relevant to ancillary joint ventures in health care area where the compensation of executives and participants are typically structured based on the revenues of the venture.<sup>391</sup> However, the revenue-sharing section was subsequently withdrawn and reserved for future guidance in both the temporary regulations, released in January 2001 (the “Temporary Regulations”), and the Regulations.<sup>392</sup>

The above example and the example contained in the Proposed Regulations also illustrate a long-held view by the IRS that a person or entity can become a disqualified person by entering into a contractual arrangement with

<sup>387</sup> Treas. Reg. § 53.4958-3(e)(2); *see also* SANDERS, *supra* note 6, Supp. § 11.3(c)(i)(A), at 157.

<sup>388</sup> H.R. REP. NO. 104-506, at 58 n.12 (1996), *reprinted in* 1996 U.S.S.C.A.N. 1143, 1181.

<sup>389</sup> Treas. Reg. § 53.4958-3(g), Ex. 7 (2002).

<sup>390</sup> *See* Prop. Treas. Reg. § 53.4958-5(d), Ex. 2., 63 (1998); *see also* SANDERS, *supra* note 6, § 11.3, at 357.

<sup>391</sup> *See* SANDERS, *supra* note 6, § 11.3(c)(ii)(B), at 356.

<sup>392</sup> *See* T.D. 8920, 2001-1 C.B. 654, 664-65, 680; Treas. Reg. § 53.4958-5 (2002). The preamble states that the temporary regulations reserve a separate section governing revenue-sharing transactions, with the IRS and the Treasury Department continuing to consider comments on the issue and any future guidance will be issued in proposed form. In the interim, all revenue-sharing transactions should be evaluated under the general rules defining excess benefit transactions (i.e., Treas. Reg. § 53.4958-4). *Id.*

an exempt organization if the contract provides such person or entity with the ability to control a portion of the exempt organization's income with no effective limitations or restrictions on possible private inurement.<sup>393</sup> This position is especially useful in an ancillary joint venture setting where an operating or partnership agreement, which governs the venture's operations, may confer enough control and influence on an otherwise unrelated for-profit participant (i.e., one who does not otherwise meet the statutory or regulatory definition of a disqualified person), that such participant can be classified as a disqualified person under the Regulations' facts-and-circumstances analysis.<sup>394</sup> This is where the "control" element discussed extensively in this Article can come into play under the proposal set forth in this Article. Specifically, the for-profit participant's control over the management and other functions of the joint venture may result in the participant being classified as a disqualified person and being subject to possible excise taxes under these rules if evidence of excess benefit being conferred by the joint venture arrangement is found. Such a classification, along with any evidence of excess benefit, as discussed below, provides the IRS with an ability to effectively evaluate such ancillary joint ventures on a case-by-case basis.

For instance, the above example in the Regulations could be modified to apply in an ancillary joint venture where the for-profit participant, rather than a management company, is given broad discretion and ultimate responsibility to manage the joint venture's activities, along with a greater percentage of the profits, pursuant to the joint venture agreement. Accordingly, the for-profit participant is deemed to be a disqualified person with respect to the exempt organization. Such a result addresses the IRS's concerns about the for-profit participant retaining too much control over the joint venture's activities while also providing the IRS with intermediate sanctions as an enforcement tool to ensure that the for-profit participant (now a disqualified person) will be subject to excise taxes and a requirement to correct the problem under Section 4958 if it receives any excess benefit under the joint venture arrangement. In addition, it provides the exempt organization with the flexibility to structure the joint venture and craft the operating agreement in a manner that ensures that the for-profit participant, although classified as a disqualified person, does not receive any excess benefit.

However, the viability of such a position in instances where the for-profit participant has no relationship, contractual or otherwise, to the exempt organization prior to the joint venture has been questioned due to the Seventh Circuit's decision in *United Cancer Council, Inc. v. Commissioner*.<sup>395</sup> In that case, the Seventh Circuit reversed the Tax Court's determination that a contract between the United Cancer Council ("UCC"), a charitable organization exempt under Section 501(c)(3), and a fundraising company unrelated to UCC prior to

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<sup>393</sup> See SANDERS, *supra* note 6, § 11.3(c)(ii)(B), at 357.

<sup>394</sup> See *supra* notes 387-89 and accompanying text.

<sup>395</sup> *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173 (7th Cir. 1999), *rev'g* 109 T.C. 326 (1997).

the contract resulted in prohibited private inurement.<sup>396</sup> The Seventh Circuit rejected the IRS's revocation of UCC's exemption on private inurement grounds, which was upheld by the Tax Court, finding that the fundraising company, completely unrelated to the UCC prior to the contract, could not be an "insider" under the private inurement rules at the time that the contract was negotiated.<sup>397</sup> The Seventh Circuit remanded the case back to the Tax Court to determine whether the contract resulted in private benefit in violation of Section 501(c)(3).<sup>398</sup> In the preamble to the Temporary Regulations, the IRS distinguishes *United Cancer Council*, which was decided after the effective date of Section 4958, by asserting that the Seventh Circuit's decision has no bearing on disqualified person status or the existence of an excess benefit transaction under Section 4958.<sup>399</sup>

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<sup>396</sup> *Id.* at 1176. Under the contract's terms, the fundraising company (Watson & Hughey) retained approximately ninety percent of the contributions received by UCC to defray the costs associated with the fundraising campaign. *Id.*

<sup>397</sup> *Id.* at 1176-79. To the contrary, the Tax Court's decision "established that an entity which had no prior relationship with the charity [exempt organization] could nonetheless become an insider for inurement purposes based on the first contract it had negotiated, and transactions under that first contract could constitute inurement." See Carolyn D. Wright, *A Conversation With Catherine E. Livingston*, 23 EXEMPT ORG. TAX REV. 485, 490 (1999). See also Streckfus, *supra* note 341, at 603-04, which stated that the government's appellate brief in the case:

[C]ited with approval a New York Bar Association report stating that insiders may include "independent contractors and other apparent third parties," and concludes that "[t]he bottom line is that the inurement prohibition serves to prevent anyone in a position to do so from inappropriately acquiring or using a charity's assets . . . for private use."

<sup>398</sup> *United Cancer Council*, 165 F.3d at 1179-80. In fact, there was a strong argument that UCC was being operated to a significant degree for private, rather than public, benefit. However, the case was settled by the parties prior to any Tax Court decision, thereby restoring UCC's exempt status and leaving the private benefit issue unaddressed and unanswered. The IRS would have had a strong private benefit argument in that UCC was in fact being operated to a significant degree for private rather than public benefit because approximately ninety percent of its contributions were being paid over to the fundraising company pursuant to the contractual arrangement.

<sup>399</sup> The preamble states:

In *United Cancer Council*, the Seventh Circuit concluded that prohibited inurement under section 501(c)(3) cannot result from a contractual relationship negotiated at arm's length with a party having no prior relationship with the organization, regardless of the relative bargaining strength of the parties or resultant control over the tax-exempt organization created by the terms of the contract. *The transactions at issue in United Cancer Council were conducted prior to the effective date of section 4958. Consequently, United Cancer Council involved interpretations of the general requirements for tax-exempt status under section 501(c)(3), and not questions of disqualified person status or the existence of an excess benefit transaction under section 4958.* Nevertheless, at the public hearing and in supplemental comments received after the hearing, commentators referenced the Seventh Circuit decision and requested that the proposed regulations be modified so that section 4958 excise taxes will not be imposed on the first transaction or contract between an applicable exempt organization and a previously unrelated person.

The temporary regulations addressed the issue raised by *United Cancer Council* by providing that section 4958 does not apply to any fixed payment made to a person pursuant to an initial contract, regardless of whether the payment would otherwise constitute an excess benefit transaction.

T.D. 8920, 2001-1 C.B. 654, 661 (emphasis added). See also Carolyn D. Wright, *UCC, IRS Settle Decade-Long Exemption Dispute: 501(c)(3) Status Revoked for Three Years*, 28 EXEMPT ORG. TAX REV. 189 (2000). Wright states:

Nevertheless, in acknowledgement of comments from the public hearing and subsequent commentary on the impact of *United Cancer Council* on the intermediate sanctions rules, the IRS addressed the issue raised in the Seventh Circuit decision by providing an "initial contract exception" in the Temporary Regulations, which was retained in the Regulations.<sup>400</sup> The issue addressed by the initial contract exception—namely, whether an initial contract between a previously unrelated person or entity and the exempt organization could result in such person or entity being classified as a disqualified person—is often referred to as the "first-bite" rule.<sup>401</sup> Prior to the Seventh Circuit's decision in *United Cancer Council*, the IRS rejected the first-bite rule by including an example in the Proposed Regulations specifically providing that an unrelated third party could be deemed a disqualified person by virtue of its first contract with an exempt organization.<sup>402</sup>

Pursuant to the initial contract exception, any binding written contract between an exempt organization and a person who was not a disqualified person immediately prior to the contract's execution will not constitute an excess benefit transaction provided that the contract provides for a fixed payment, including a fixed formula, and the amount of such payment or the decision to make the payment is not subject to any discretion.<sup>403</sup> The exception will not apply if the parties materially modify the contract.<sup>404</sup> At first glance, it appears that this initial contract exception is a major hurdle for the IRS to clear before effectively using the intermediate sanction rules in the ancillary joint venture setting. For instance, even if the operating agreement or other agreement associated with the joint venture allows the for-profit participant, who has no dealings with the exempt organization prior to the commencement of the joint venture, to receive an excess benefit, this initial contract exception will effectively prevent the application of any excise tax even if the joint venture arrangement results in the for-profit participant constituting a disqualified person.<sup>405</sup> However, the following statement in the preamble to the Temporary

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[Former IRS Exempt Organizations Division Director Marcus S.] Owens noted that Congress intended those with 'substantial influence' over an exempt organization be considered disqualified persons, which indicates that outsiders could fall into this category. Because Judge Posner was not interpreting section 4958 in the UCC case, Owens predicts that the final regulations will look more to legislative history than to the Seventh Circuit's opinion for guidance on the appropriate health of the disqualified person definition.

*Id.*

<sup>400</sup> See Treas. Reg. § 53.4958-4(a)(3) (2002).

<sup>401</sup> See Darryll K. Jones, *Law Professor Criticizes Intermediate Sanctions Regs.*, 33 EXEMPT ORG. TAX REV. 419 (2001).

<sup>402</sup> *Id.*; see also *supra* note 390 and accompanying text.

<sup>403</sup> Jones, *supra* note 401. In order to be deemed a "fixed payment" under this exception, it must be specified in the contract or agreement or determined by a fixed formula specified therein. A "fixed formula" may incorporate an amount that depends on future specified events or contingencies, but no person may exercise discretion as to the calculation or whether the payment is to be made.

<sup>404</sup> *Id.*

<sup>405</sup> Despite its acknowledgement of the issue raised by *United Cancer Council* in its statements regarding the initial contract exception in the preamble to the Temporary Regulations, the IRS still appears to adhere to its original position that an unrelated person can become a disqualified person by entering into a contract with an exempt organization, even if the initial contract exception applies, as shown by the following example in the Regulations:

Regulations illustrates the IRS's perceived flexibility in circumventing the exception:

In effect, the initial contract rule contained in the temporary regulations protects from section 4958 liability those payments made pursuant to fixed, objective terms specified in a contract entered into before the person was in a position to exercise substantial influence, *yet allows for scrutiny under section 4958 to the extent the contract allows for subsequent discretion to be exercised (which may be subject to influence by the disqualified person)* when calculating the amount of a payment or deciding whether to make a payment.<sup>406</sup>

This discretion component was likewise integrated into the definition of a "fixed payment" under the Regulations.<sup>407</sup> For example, if the for-profit participant in a joint venture is the managing member of the venture pursuant to the operating agreement and the agreement provides such managing member the discretion to make or withhold distributions of the venture's net earnings, such discretion may be enough to nullify the initial contract exception and enable the IRS to assert excise taxes if the managing member otherwise qualifies as a disqualified person, as discussed above, and receives an excess benefit under the terms of the joint venture.

## 2. Excess Benefit in an Ancillary Joint Venture

As previously defined, an excess benefit results when the amount of the economic benefit conferred by an exempt organization to a disqualified person exceeds the fair market value of the consideration provided by such person in return.<sup>408</sup> The excess benefit is the amount by which the benefit exceeds the value of the consideration.<sup>409</sup> The Regulations acknowledge that any excess benefit can be conferred to a disqualified person *indirectly* by means of an entity controlled by, or affiliated with, an exempt organization (i.e., attribution).<sup>410</sup> For instance, an exempt organization may not avoid possible imposition of intermediate sanctions by using a corporation or partnership, in which it owns greater than a fifty percent interest, to pay excessive compensation to one of its executives.<sup>411</sup> Accordingly, pursuant to the Regulations' attribution rules, an excess benefit transaction can occur in a joint venture setting where the joint venture entity pays excessive compensation or management fees to a disqualified person.

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Hospital C, an applicable exempt organization, enters into a contract with Company Y, under which Company Y will provide a wide range of hospital management services to Hospital C. *Upon entering into this contractual arrangement, Company Y becomes a disqualified person with respect to Hospital C.*

Treas. Reg. § 53.4958-4(a)(3)(vii), Ex. 7 (2002) (emphasis added); *see also* SANDERS, *supra* note 6, Supp. § 5.4(b)(ii), at 103.

<sup>406</sup> T.D. 8920, 2001-1 C.B. 654, 661-62 (emphasis added).

<sup>407</sup> Treas. Reg. § 53.4958-4(a)(3)(ii)(A) (2002). Specifically, the Regulations provide that a fixed formula specified in the agreement "may incorporate an amount that depends upon future specified events or contingencies, *provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment.*" *Id.* (emphasis added).

<sup>408</sup> *See supra* notes 370-73 and accompanying text.

<sup>409</sup> Treas. Reg. § 53.4958-4(a)(1) (2002).

<sup>410</sup> Treas. Reg. § 53.4958-4(a)(2) (2002).

<sup>411</sup> *See* Treas. Reg. § 53.4958-4(a)(2)(iv), Ex. 2 (2002).

Another possible situation of excess benefit being conferred in a joint venture arrangement is the contribution of property by participants in the joint venture to the venture entity in exchange for an ownership interest therein. Clearly, if the transferred property is overvalued or, for example, if the for-profit participant receives an interest in the joint venture entity (i.e., benefit) that exceeds the fair market value of the property transferred to such entity by such participant, an excess benefit has been conferred.<sup>412</sup> The IRS clearly views joint ventures as possibly conferring an excess benefit as stated in the IRS's Hospital Audit Guidelines, which provide certain factual scenarios in which private inurement (or excess benefit) may arise:

- (1) participation in the venture imposes on the tax-exempt health care organization obligations that conflict with its exempt purposes;
- (2) there is a disproportionate allocation of profits and losses to the nonexempt (usually limited) partners (usually physicians);
- (3) the exempt partner makes loans to the partnership that are commercially unreasonable (because of a low interest rate or inadequate security);
- (4) the exempt partner provides property or services to the partnership at less than fair market value; and/or
- (5) a nonexempt partner receives more than reasonable compensation for the sale of property or services to the joint venture.<sup>413</sup>

Despite the IRS's acknowledgement in other guidance that joint ventures can create real instances of private inurement or excess benefit, the Regulations are not explicit as to whether an excess benefit can be conferred in a joint venture arrangement, absent compensation or other management fees being paid to the for-profit participant. Specifically, the Regulations do not address whether a for-profit participant's distributive share from a joint venture with a tax-exempt participant can meet the definition of an excess benefit.

As previously stated, revenue-sharing arrangements are relevant when discussing joint ventures, particularly in the context of excess benefit. The statutory definition of an excess benefit transaction, in addition to the one above, also "includes any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of [one] or more activities of the [exempt] organization, but only if [the] transaction results in [private inurement]."<sup>414</sup> In this context, the excess benefit is the amount of the private inurement.<sup>415</sup> In the health care

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<sup>412</sup> In determining whether the transfer of property constitutes an excess benefit transaction, the Regulations adopt a straightforward approach by determining whether the consideration paid exceeds the fair market value of the property transferred.

Fair market value" is defined as "the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts.

Treas. Reg. § 53.4958-4(b)(1)(i) (2002); *see, e.g.*, Caracci, et ux, et. al. v. Comm'r, 118 T.C. 379 (2002) (excess benefit transaction found and intermediate sanctions imposed based primarily on valuation issues).

<sup>413</sup> Hospital Audit Guidelines, *supra* note 351, at § 333.4(3).

<sup>414</sup> I.R.C. § 4958(c)(2) (2004).

<sup>415</sup> *Id.* *See also* HOPKINS, *supra* note 50, § 19.11, at 535.

sector, revenue-sharing arrangements are commonplace in ancillary joint ventures involving tax-exempt hospitals and physicians or other for-profit parties.<sup>416</sup> The distributions from such joint ventures, in and of themselves, represent revenue-sharing from the ventures' operations.<sup>417</sup> In the Proposed Regulations, the section devoted to revenue-sharing arrangements attempted to address this issue head-on, although again not explicitly in the context of a distributive share to the for-profit participant in a joint venture with an exempt organization. The Proposed Regulations generally provided that a "revenue-sharing arrangement [could] constitute an excess benefit transaction regardless of whether the economic benefit provided to the disqualified persons exceeds the fair market value of [services rendered] in return, [if a] disqualified person [is permitted] to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose."<sup>418</sup> Accordingly, the Proposed Regulations considered an improper revenue-sharing arrangement, *in its entirety*, to constitute an excess benefit subject to Section 4958.<sup>419</sup> Examples provided in the Proposed Regulations further established that an excess benefit transaction could occur when an exempt organization permitted a for-profit partner in a joint venture to control the amount of income received by the for-profit, unless the exempt organization received a "proportional benefit" as the for-profit's benefit increased.<sup>420</sup>

The proportional benefit issue as well as a host of other issues raised in response to the Proposed Regulations ultimately led to the IRS abandoning the revenue-sharing provision, reserving a section in the Temporary Regulations and Regulations for future guidance,<sup>421</sup> and providing that all revenue-sharing

<sup>416</sup> Thomas K. Hyatt, *Revenue Sharing Arrangements*, materials for AHLA conference on Tax Issues for Health care Organizations (October 2001).

<sup>417</sup> *Id.*

<sup>418</sup> Prop. Reg. § 53.4958-5 (1998); see also Janice M. Smith, *Intermediate Sanctions and Reasonable Compensation*, 44 TAX MGMT. MEMO. 195 (June 2, 2003)

<sup>419</sup> Preamble, T.D. 8920, 2001-1 C.B. 654, 660-61.

<sup>420</sup> SANDERS, *supra* note 6, § 11.3(c)(ii)(B), at 358. Sanders explained that the examples in the revenue-sharing section of the Proposed Regulations were similar to the analysis used in determining whether an exempt organization's participation in a joint venture with a for-profit entity furthers its exempt purposes, referring directly to Revenue Ruling 98-15 and the analysis thereunder. "In excess benefit analysis," he provides, "the issue is whether the nonprofit has control over its income stream or whether a person or entity with profit motives has control." *Id.*

<sup>421</sup> See *supra* note 392 and accompanying text. As to comments received on the Proposed Regulations, some balked at a separate standard being applied to revenue-sharing arrangements in comparison to all other transactions while others urged the IRS to adopt a standard based on approaches taken in prior administrative rulings. Some comments urged the IRS to make the rebuttable presumption available to revenue-sharing arrangements. Preamble, T.D. 8920, 2001-1 C.B. 654. Among other issues, the American Bar Association's formal comment on the Proposed Regulations specifically took issue with the fact that a person's ability to control activities that generate the revenue on which his or her compensation is based could be used in determining whether such person was a disqualified person under the regulations. Furthermore, in acknowledging that compensation arrangements that incorporate economic productivity as a component are common and useful in the health care industry, the comment states that "[a]t a minimum, we believe that the final regulations should make clear that a compensation arrangement based on an employees' productivity does not tend to show that such person has substantial influence absent other facts and circumstances." See SANDERS, *supra* note 6, § 11.3(c)(ii)(B), at 358 (citing "American Bar Association Comment

arrangements should be evaluated under the general provisions of the Regulations defining excess benefit transactions, "which apply to all transactions with disqualified persons regardless of whether such person's compensation is computed by reference to the revenues of the organization [or venture]."<sup>422</sup> Despite the IRS's abandonment of the revenue-sharing issue in the Regulations and reservation of a section for future guidance,<sup>423</sup> the IRS's attempt to address the issue in the Proposed Regulations does shed some light on the topic at hand. First, it reveals the IRS's viewpoint that revenue-sharing arrangements, which are implicit in ancillary joint ventures, are significant sources for possible private inurement and excess benefit. Second, it further exposes the likelihood that the IRS will apply the intermediate sanctions rules to revenue-sharing arrangements that otherwise meet the requirements under Section 4958 and the Regulations. Finally, the IRS's reservation of a section in the Regulations to address revenue-sharing arrangements presents the agency with a current opportunity to both address instances where ancillary joint ventures might result in excess benefit to the for-profit participant(s) and provide some meaningful guidance as to the use of the intermediate sanctions in such instances.

Private benefit to the for-profit participant in an ancillary joint venture is a natural consequence of the venture. To address the IRS's concern that too much benefit is being conferred by the joint venture arrangement, the second prong of this Article's alternative proposal recommends utilizing the intermediate sanctions rules more effectively. For the IRS to do so, it must issue additional guidance that illustrates more clearly when a for-profit participant constitutes a disqualified person under the rules and when ancillary joint ventures will result in excess benefit to the for-profit participants. This additional guidance will not only provide the IRS with options other than revocation to address joint ventures that confer too much benefit to their for-profit participants, but it will also increase compliance because exempt organizations and their advisors will possess better-defined parameters to assist them in structuring their joint venture arrangements with for-profit participants properly.

#### *E. Potential Criticisms of the Second Prong of the Alternative Proposal*

Any proposal for change elicits potential criticism and the alternative proposal set forth in this Article is no different. The primary criticism that will likely be levied against the second prong of this Article's alternative proposal centers on one of the primary differences between the concepts of private benefit and private inurement—private inurement requires that there be an "insider" (or disqualified person under the intermediate sanctions rules) where private benefit can apply where impermissible benefit is conferred on unrelated third parties or non-insiders.<sup>424</sup> Under the intermediate sanctions rules, a for-profit participant that is unrelated to the exempt organization prior to the joint venture does not meet the definition of a disqualified person because of a restriction imposed by the "first-bite" rule or the "initial contract exception" in the Regu-

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on Intermediate Sanctions Proposed Regulations Under I.R.C. Section 4958," *reprinted at* BNA TAX CORE, March 1, 1999).

<sup>422</sup> See Preamble, T.D. 8920, 2001-1 C.B. 654.

<sup>423</sup> See Treas. Reg. § 53.4958-5 (2002).

<sup>424</sup> See *supra* notes 72 and 73 and accompanying text.



lations.<sup>425</sup> Accordingly, the criticism will assert that such rule or exception effectively prevents the application of intermediate sanctions in numerous instances.

With respect to that potential criticism, it is important to illustrate the many instances in which the initial contract exception will not apply, thus leaving open the possible application of the intermediate sanctions rules. Specifically, the exception will not apply in instances where: (i) The other party to the first or initial contract already qualifies as a disqualified person for reasons not relating to the terms of the contract at issue; (ii) it is not the initial contract between the exempt organization and a person or entity that may qualify as a disqualified person due to the contract's terms or other changes in their relationship with the exempt organization; (iii) it is the initial contract, but such contract is later materially modified; (iv) it is the initial contract and the contract provides a fixed payment or fixed formula, but the amount of the payment and/or the decision to make the payment is subject to any discretion; (v) it is the initial contract but such contract does not provide for a fixed payment or fixed formula, regardless of whether there is any discretion in calculating or making the payment; or (vi) it is the initial contract but the other party to the contract "fails to perform substantially the person's obligations under the initial contract."<sup>426</sup>

Accordingly, there are numerous instances where the for-profit participant in a joint venture with an exempt organization is not precluded from classification as a disqualified person due to the initial contract exception under the Regulations and, thus, is potentially subject to intermediate sanctions. Furthermore, as previously stated, the IRS's reservation of a section in the Regulations to address revenue-sharing arrangements presents the agency with the perfect opportunity to further elaborate on the application of the initial contract exception to for-profit participants in ancillary joint ventures, especially in instances where such participants have the "discretion" or other ability to control any aspect of the decision regarding distribution of the venture's net earnings.

In addition, the initial contract exception or "first-bite" rule is not without its own detractors or criticism. For instance, Professor Darryll Jones argues that the Seventh Circuit's decision in *United Cancer Council* and, therefore, the Regulations' initial contract exception, "focuses on the wrong moment in time. The recipient is not an insider at the making of the contract, but neither is the surplus wealth distributed at that time. Of course there is no profit-taking violation."<sup>427</sup> However, when a distribution is made after the contract is signed, the recipient's status has changed to that of an "insider" or disqualified person due to the contract's terms.<sup>428</sup> Therefore, according to Professor Jones, the Seventh Circuit's decision and the IRS's adoption of the initial contract exception can result in an exempt organization distributing its profits to an insider or disqualified person.<sup>429</sup>

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<sup>425</sup> See *supra* notes 400-07 and accompanying text.

<sup>426</sup> Treas. Reg. § 53.4958-4(a)(3)(iv) (2002); see also *supra* notes 4033-4077 and accompanying text.

<sup>427</sup> Jones, *supra* note 401, at 419.

<sup>428</sup> *Id.* at 420.

<sup>429</sup> *Id.*

The fact of an unreasonable payment and the recipient's status *as of the date of the unreasonable payment* are the sole determinants. Whether the payment and achievement of insider status were determined by the same contractual arrangement is *irrelevant* to the profit-taking prohibitions [private inurement doctrine; intermediate sanctions rules] because the harm is identical (a controlling individual is taking profit from the charity [exempt organization]).<sup>430</sup>

Accordingly, Professor Jones proposes in part that the IRS should reject the "first-bite" rule (i.e., the initial contract exception in the Regulations).<sup>431</sup> Clearly, the elimination of the initial contract exception would ensure a broader application of the intermediate sanctions rules to ancillary joint ventures. Accordingly, Professor Jones's proposal only further supports this Article's proposed use of the intermediate sanctions rules to determine the proper federal income tax treatment of ancillary joint ventures more effectively with respect to the benefit received by the for-profit participants from the venture.

In addition to Professor Jones's criticism of the first-bite rule, tax practitioners, in response to Congressional concerns with respect to compensation paid by exempt organizations, have proposed several modifications to Section 4958, including two changes that would limit the application of the first-bite rule. In response to such Congressional concerns, the Section of Taxation of the American Bar Association ("ABA Tax Section") submitted a letter dated September 15, 2004 to the leaders of the Senate Finance Committee addressing various concerns, including the initial contract exception contained in the Regulations.<sup>432</sup> In the context of determining whether compensation paid is reasonable, legislative staff members of the Finance Committee specifically expressed concerns as to "whether excluding the initial contract from Section 4958, as the Regulations currently require, is appropriate."<sup>433</sup> Upon deferring to "Congress' judgment that an initial contract exception is appropriate where the non-exempt party to the contract is not yet in a position to exercise substantial influence over the exempt party," the ABA Tax Section proposes two modifications to the initial contract exception.<sup>434</sup> The first recommendation is to limit the exception to two years, which the ABA Tax Section stated "will allow nonprofit organizations the flexibility they need while ensuring that the compensation of recently hired individuals is re-examined under the Section 4958 standards within a reasonable period of time."<sup>435</sup> The second recommendation is to extend the rebuttable presumption of reasonableness to initial contracts for

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<sup>430</sup> *Id.* (emphasis added).

<sup>431</sup> *Id.* Professor Jones also argues that the private benefit doctrine, as defined in Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) and as interpreted by the decision in *American Campaign Academy*, is "insufficient to address profit taking to persons who become insiders by virtue of the same contract by which profit is distributed." *Id.* Accordingly, he proposes a restatement of the private benefit doctrine to specifically address the inequity currently resulting from the application of the first-bite rule. *Id.*

<sup>432</sup> Katherine E. Stimmel, *ABA Tax Section Recommends Modifying, Not Shelving, Section 4958 Compensation Rules*, DAILY TAX REP. (BNA), Sept. 30, 2004, at G-7.

<sup>433</sup> *Id.*

<sup>434</sup> *Id.*

<sup>435</sup> *Id.*

the two-year period, provided the exempt organization adheres to the procedures set forth in the Regulations for obtaining such presumption.<sup>436</sup>

Clearly, the ABA Tax Section's response attempts to address in part the concerns raised by Professor Jones with respect to the first-bite rule—namely, that the rule focuses on the wrong moment in time. By limiting the rule's applicability to only two years, the ABA Tax Section implicitly recognizes that an unrelated third party that enters into an initial contract with an organization can become a disqualified person with respect to such organization by the very terms of the contract and, therefore, a time limit on the initial contract exception will eliminate any long-term private inurement or excess benefit that may result from such contract. Although the ABA Tax Section's recommendations do not specifically address ancillary joint venture arrangements, as with Professor Jones's proposal, any limitation on the initial contract exception will ensure a broader application of the intermediate sanctions rules to ancillary joint ventures. Accordingly, such a limitation only further supports this Article's proposed use of the intermediate sanctions rules to more effectively determine the proper federal income tax treatment of ancillary joint ventures with respect to the benefit received by the for-profit participants from the venture.

The current political climate surrounding exempt organizations<sup>437</sup> and their activities, as well as Congress's concerns with the effectiveness of the intermediate sanctions regulations, present the IRS with the perfect opportunity to revisit not only the effectiveness of the initial contract exception but also the application of the intermediate sanctions rules to ancillary joint ventures. Any issuance of additional guidance clarifying and solidifying such application of the intermediate sanctions rules will not only be effective in addressing Congressional concerns as to exempt organizations' compensation practices, but should also be effective in providing guidance that is more practical and applicable to exempt organizations attempting to structure transactions and joint ventures that satisfy such rules.

## V. CONCLUSION

The proposal set forth in this Article provides a more viable alternative to the IRS's current control standard in determining the proper federal income tax treatment of ancillary joint ventures. The IRS's control standard is inappropriate and economically unrealistic because an ancillary joint venture, by its very definition, is not the exempt organization's primary activity and, thus, may only represent an insignificant or relatively small portion of its overall activities whether measured in time, expenditures, or both. As an alternative to this control standard, the IRS need only look to the resources already available to it in the form of the UBIT and the intermediate sanctions rules. This two-prong approach to determining the federal income tax consequences of participation in ancillary joint ventures will provide exempt organizations and tax practition-

<sup>436</sup> *Id.* See also Treas. Reg. § 53.4958-6 (2002) with respect to the rebuttable presumption of reasonableness. The ABA Tax Section believes that this second recommendation provides a "significant motivation to nonprofit organizations to adhere voluntarily to the rebuttable presumption standards." *Id.*

<sup>437</sup> See *supra* notes 2-5, 433 and accompanying text.

ers with more defined parameters in attempting to structure their joint venture arrangements with for-profit participants.

The proposal set forth herein requires the IRS to consider issuing additional guidance. First, with respect to the first prong of the proposal, although the IRS took some initial steps by employing in part a UBIT analysis in Revenue Ruling 2004-51, it nevertheless needs to expand its use of the UBIT to provide guidance in the context of joint ventures where: (i) the exempt organization possesses less than a fifty percent ownership interest or does not have exclusive control of the joint venture's activities; or (ii) the activities of the joint venture are not substantially related to the exempt organization's primary exempt activities. In addition, the IRS needs to provide guidance that provides a more clearly-articulated and consistently-applied standard as to what constitutes "insubstantial" or "substantial" unrelated business activity under the UBIT rules, which will provide exempt organizations and their tax advisors with greater certainty.

As to the second prong of the proposal, the IRS must issue additional guidance, perhaps in the section of the Regulations reserved for revenue-sharing arrangements, that illustrates more clearly when ancillary joint ventures might result in excess benefit to the for-profit participant and provides more meaningful guidance as to when Section 4958 and the sanctions thereunder may be applied to such situations. Specifically, the IRS needs to reconsider the viability and effectiveness of the initial contract exception under the Regulations not only because, as presently stated, it may effectively bar Section 4958 from being applied to certain ancillary joint ventures that might otherwise qualify as excess benefit transactions, but also because of Congressional concerns that the IRS and the intermediate sanctions rules are not effectively addressing the perceived problem of excessive compensation by exempt organizations.

The issuance of additional guidance that defines more clearly how and when the UBIT and the intermediate sanctions rules may be applied to ancillary joint ventures can only yield positive results. First, the IRS will be able to utilize both sets of rules more effectively in determining the proper federal income tax treatment of exempt organizations' participation in ancillary joint ventures. More importantly, exempt organizations and their advisors will possess better-defined parameters to assist them in structuring their joint venture arrangements with for-profit participants properly.